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OVERSIGHT HEARINGS ON THE CONDITION OF THE BANK INSURANCE FUND

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

THE U.S. GENERAL ACCOUNTING OFFICE AND THE CONGRESSIONAL BUDGET OFFICE ON THE OUTLOOK FOR THE BANK INSURANCE FUND AND RECOMMENDATIONS FOR ACTIONS TO REMEDY THE DEFICIENCIES

SEPTEMBER 11 AND 12, 1990

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OVERSIGHT HEARINGS ON THE CONDITION OF THE BANK INSURANCE FUND

TUESDAY, SEPTEMBER 11, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:04 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee), presiding.

Present: Senators Riegle, Sarbanes, Dixon, Sanford, Shelby, Kerry, Graham, Garn, Heinz, and D'Amato.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome all those in attendance. We have some people coming into the room, so let me welcome everyone. We have some empty chairs on this side, so maybe we can get people in and seated before we begin this morning.

We're very pleased to have before the committee this morning Charles Bowsher, who is, of course, the Comptroller General of the United States who has appeared here many times and brings us important information and findings today.

We're very pleased to have you and after we've made our opening statements, I'll call upon you for your report to us.

I think we all know that the American people are rightly concerned about the cost of the thrift problem and the potential cost of problems that exist and seem to be building in the banking industry.

Several academic experts have made public statements that have been heightening these concerns. Those sources say that a number of banks, including some very large banks, and the Bank Insurance Fund itself, are not nearly as strong as they might appear.

One particular critic, Robert Litan of the Brookings Institution, has testified to that effect before this committee last October.

Mr. Seidman, while expressing some concerns himself, disagrees with some of the statements of those critics, but he acknowledges that the insurance fund is under stress and will lose money again this year, and that will be the third year in a row for those losses.

To help replenish the fund, Chairman Seidman has proposed to raise the insurance premiums that banks will have to pay in 1991 to the maximum level permitted by last year's FIERRA legislation.

The concern here, and it needs to be underscored, is not that depositors are at risk of losing their money within the limits of the insurance law. Certainly, the law that's in place, and our experience shows, in the bank or S&L failures, that the Federal Government stands behind the insured deposits. Depositors will always receive their deposits in the event of the closure of a federally insured institution.

So the fear ought not to lie in that area, but, rather, with the question of taxpayers having to come forward with some form of rescue of the bank fund itself, such as we have seen in the savings and loan situation.

Now, the two situations are different in a number of very important respects, and that will be highlighted today. But it must also be said that the amount of money in the Bank Insurance Fund is now about half of the minimum that ought to be there, and has been declining. The roughly $13 billion that is in the fund at the present time is there insuring something close to $3 trillion worth of deposits. And I'm sure that some of these numbers will be presented to us today.

Now, obviously, bank capital and the value of assets behind the loans that have been made stand between the insurance fund and the banks within the banking system.

But, in any case, we're down to a paper-thin margin that may not be nearly as strong or as large as it is reported to be.

And that is why we have asked the General Accounting Office, which is an independent arm of the Government constructed to take a detached, but an in-depth look at this problem, and to give us their very carefully considered opinion of the condition of commercial banks in the United States and their insurance fund or, if you will, our insurance fund.

So responding to my request, Mr. Charles Bowsher, accompanied by three of his staff whom he will introduce, is here with us this morning to present the GAO's annual audit of the Bank Insurance Fund for 1989.

I'd just say one other thing. What GAO has to say to us is of great importance. It is a matter of great concern. Tomorrow, we will also be hearing from the Congressional Budget Office, which give their assessment of the same situation. And so, I would draw your attention to the fact that we will have another professional opinion on this subject tomorrow to add to the one that we get today.

So with that, Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator **GARN**. Thank you, Mr. Chairman.

Mr. Chairman, today's hearing on the condition of the banking system raises extremely important concerns for the Congress and the country. We have all seen the press accounts concerning the downturn in the real estate sectors of our economy, particularly in the northeast and the southwest. We have all read the stories of important financial institutions being forced to take very large losses or being closed.

Today, Mr. Bowsher's testimony provides us with a quantitative measure of the seriousness of the problems in the banking industry, and the news is certainly not good.

The FDIC is facing significant problems. The deposit insurance fund has had 2 successive years of losses. The FDIC's reserves are at an all-time low and the failure of additional large institutions is possible.

Yesterday, Chairman Seidman indicated that the FDIC could lose as much as $2 billion this year. If conditions in the economy deteriorate, the loss might even be greater.

Mr. Chairman, the GAO's testimony today, along with the testimony the committee will receive tomorrow and next week, should provide us with a clearer picture of the condition of the banking system. A similar portrait was painted in the mid-1980's regarding the condition of our thrift system.

Witness after witness came before the committee at that time trying to urge that we take action to shore up the FSLIC fund and provide the Bank Board with the tools that it needed to take effective action. Mr. Bowsher himself warned us about the severe problems in the thrift industry.

This committee and the Senate took action at that time in passing a $15 billion FSLIC recapitalization in October 1986. Unfortunately, the House of Representatives ignored those warnings and the result has become a national tragedy.

Mr. Chairman, I hope that today we will demonstrate that we have learned our lesson. Benign neglect will not work. If the conditions warrant action, we must take that action and not put off until tomorrow the hard decisions that we should be making today.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I'll be very brief.

First of all, I want to commend you for holding this hearing and, in fact, for a general approach that has sought to get ahead of the curve in terms of anticipating the developments.

I think that's very important and I, for one, am very pleased to see the committee exercising its oversight responsibilities on some very important matters and hopefully, trying to focus attention before it's a crisis of such magnitude that it demands attention.

Second, I want to welcome the Comptroller General and his associates to the committee and simply say that I have a great respect for the quality of their work.

I think consistently over the years, they've done the kind of analysis that, in many respects, I wish both the administration and the Congress had paid more attention to. I perceive their report this morning as in that category. I simply want to thank the Comptroller General for their efforts.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Sarbanes.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I want to join you and our colleagues in welcoming the Comptroller General, Chuck Bowsher.

As I looked over your testimony, Chuck, I couldn't help but feel that if Charles Dickens had been editing it for you, he would have said that, "These were the worst of times, and the worst of times," because you paint a very serious, alarming, and potentially depressing picture of the Bank Insurance Fund, particularly when you warn that a recession—and we have areas of this country that are in a recession right now—could result in not only the bankruptcy of the Bank Insurance Fund, but require another bail-out by the American taxpayers.

It's all the more alarming because at last year's hearing on the condition of the banking industry, the Chairman of the FDIC, Bill Seidman, predicted that the FDIC had turned the corner. He said that we were headed for better times in 1990.

Well, it looks like when Bill Seidman turned the corner, he didn't end up on Easy Street. Instead, the Bank Insurance Fund got mugged to the tune of $2 billion.

Confronting the problems of the banking industry is important. But I think we still need to understand better, the root causes for the losses being suffered by the Bank Insurance Fund.

Is the poor financial condition of the banking industry caused by poor management? Is there something inherently wrong with the deposit insurance system? Is it the result of Murphy's law or is it the result of Federal law?

We all believe in this committee that a healthy banking industry is critical. It's essential to our Nation's economy.

The recent credit crunch that so many of us have been concerned about is a reminder that there are many small businesses—farmers, consumers and others—that rely, and must rely, on a sound banking system.

So I hope, Mr. Chairman, that our witness today can shed some light not only on where we are, but how we got there and how we can, in this case, fashion some policies to turn in a better direction.

The CHAIRMAN. Thank you, Senator Heinz.

Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

I, too, wish to join in applauding you for holding this series of hearings.

I have a prepared statement that I would like to submit for the record.

The CHAIRMAN. We'll make it a part of the record.

OPENING STATEMENT OF SENATOR GRAHAM

Senator GRAHAM. But if I could briefly comment on an editorial which appeared in this morning's Washington Post, under the headline, "Reform Deposit Insurance," that editorial concludes with this paragraph.

> The present insurance system can be refined to the benefit of both the public and the Treasury. But the principle of deposit insurance is entirely sound. Blaming it for the S&L bankruptcies is like blaming your insurance policy for the fire that burned your house down.

[Newspaper article follows:]

[From the Washington Post, Sept. 11, 1990]

REFORM DEPOSIT INSURANCE?

Congress is now getting to work on reform of the deposit insurance system. The prevailing opinion is that deposit insurance was responsible for the enormous losses of taxpayers' money in the S&L bankruptcies and that the great lesson of that unhappy experience is the need to limit deposit insurance sharply. But before you accept that thought, you ought to consider another lesson of those bankruptcies.

While the United States has just been through an enormous wave of financial collapses, the unemployment rate has been untouched by it. In those collapses, S&L's lost huge amounts of their depositors' money—probably well over $150 billion—but no one has lost a job as a result of it except the people who worked directly for those S&L's themselves. There was no cascading effect, as there was in 1933, when banks' failures destroyed businesses that were their customers. A bank's failure could wipe out its depositors, forcing them to default on their mortgages and debts, in turn throwing other banks and businesses into jeopardy.

Americans have forgotten how financial panics used to sweep through the country, turning financial failures into depressions. It hasn't happened since deposit insurance was enacted two generations ago. For all the things that went wrong in the financial world of the 1980's, the deposit insurance system worked. It prevented the S&Ls' losses from becoming contagious and spilling over into the real economy of jobs, production, sales and investment.

The system can certainly be improved, and Congress is quite right to reconsider it. The calendar for the coming months is crowded with hearings on the subject. But any reform will be dangerously misguided if it succeeds in reducing risks to the Federal Government only by increasing risks to depositors.

Congress has repeatedly been told that it was the deposit insurance that accounts for the tremendous costs of the S&L fiasco. Wrong. It was deposit insurance that has thrown the losses into the Federal budget rather than onto depositors. Some economists have been arguing that less deposit insurance, or none, would make both S&L managers and their depositors more prudent. That idea is more attractive in theory than in practice.

The present insurance system can be refined to the benefit of both the public and the Treasury. But the principle of deposit insurance is entirely sound. Blaming it for the S&L bankruptcies is like blaming your insurance policy for the fire that burned your house down.

Senator **GRAHAM**. I find several problems with the analysis in that editoral which I think goes to the core of the discussion that we are currently engaged in.

One, I don't believe that the deposit insurance program is in fact insurance. Insurance is generally defined as the shifting of risk for compensation. That infers that there is some actuarial assessment of what the risk is worth and that a premium is paid commensurate with that cost.

In your testimony later today, Mr. Bowsher, you're going to comment, I believe, that you do not believe that there is any actuarial basis for the 1.25 ratio which is supposedly the standard by which the FDIC fund is predicated.

So a fundamental principle of insurance is defined.

Second, insurance infers some relationship of specific activity to specific level of compensation. A 16-year-old will typically pay more for automobile insurance than a 45-year-old, based on experience and propensity for accidents.

We have not had any individualization in terms of either the thrift or the commercial bank premium policy. There's no relationship between risk to the fund and premiums paid.

And third, while we state that there is a $100,000-per deposit limit, in fact, there has been a tendency for a "Too big to fail" concept and the insurance plan to cover everybody. It would be a person who buys a $50,000 automobile insurance policy and ends up with a $100,000 claim and the insurance company is saying, well, we'll pay the $100,000, even though our policy limits were $50,000.

The editorial in the Post talks about the fact that one of the benefits of deposit insurance is that it has protected small businesses from going under in the event of a bank failure. Well, the reason is because we haven't followed the principle of limiting the insurance coverage to what is the stipulated amount.

So I believe that we are not really talking about insurance here. We're talking about, at best, a public subsidy and, at worst, a public casino which has privatized profits and socialized losses.

I'm concerned about the series of statements that we've had over the last few months as to the state of the FDIC fund which are eerily similar to those we heard in 1988 as to the state of the thrift insurance fund.

We've seen in the subsequent months how far from those representations the thrift insurance fund was in. I'm concerned as to what the gap is between representation and reality of the FDIC fund.

In conclusion, Mr. Chairman, the final question I'm going to be particularly interested in is what should Congress be doing now?

We were told in 1988 that we shouldn't do anything, that to do anything would create the impression of a problem or a crisis when neither existed.

I don't want and do not expect that such independent and objective observers as Mr. Bowsher and his colleagues would lead us into that trap. But if we have a fire in our house, I want us to call out the emergency crew as quickly as possible and not wait until we're dealing with the ashes of another financial debacle.

Thank you.

[The complete prepared statement of Senator Graham follows:]

PREPARED STATEMENT OF SENATOR BOB GRAHAM

Mr. Chairman, your hearings this week on the Bank Insurance Fund are very timely. I have been concerned about the Bank Insurance Fund [BIF] since the middle of July when Mr. William Seidman, Chairman of the Federal Deposit Insurance Corporation [FDIC] stated that the BIF is "under considerable stress" and "would be in trouble" were the Nation to suffer a serious recession. Mr. Seidman said, "but if things come along, major failures that we are not able to foresee at this time, that would be another story. The system is under stress."

Mr. Chairman, as I read those statements, I had a sense of recall of similar statements being made back in 1988 relative to the Federal Savings and Loan Insurance Corporation [FSLIC].

At that time Chairman Wall of the Federal Home Loan Bank Board said; "The Board projects the FSLIC possesses adequate resources in the near term to deal effectively with problem institutions in the thrift industry. This projection depends upon other segments of the thrift industry remaining stable and assumes no significant increase in interest rates or dramatic downturn in other sectors of the economy."

I was troubled with the pattern of representations in 1988 by Mr. Wall and Treasury's Mr. Gould that showed that FSLIC situation to be so distant from the reality. Today, I am troubled by the similar statements we are hearing from Chairman Greenspan and Treasury Secretary Brady.

Mr. Chairman, I look forward to the testimony on the Bank Insurance Fund and hope that it helps to clarify the true financial picture of the fund as well as to provide recommendations to Congress on any steps we should be taking to help the fund.

The CHAIRMAN. Thank you, Senator Graham.

Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, I want to commend you for calling these hearings. I think that Senator Graham sounded the right note in putting forth the challenge as to what can and should we practically be undertaking for what we recognize as a problem out there, instead of waiting for that problem to become more critical? And then the question is asked of us, why did you not go forth if you saw this taking place? How did you let it get as bad as it's gotten?

And if it is dangerous and if it's going to cost us money, and I think it will—there's no doubt in my mind, because as I read through the report, you talk about how much greater the losses can and will be due to adverse economic conditions, and those conditions are here.

And I hear this talk about, are we in a recession? Or when will we, and what figures trigger it off?

We certainly are. And it's not isolated to one or two regions.

So, recognizing that, what can we do? And certainly, we don't want to overreact, to exacerbate the problem, which I think is also one of the things that Senator Graham has touched on. But what should we be doing in light of a realistic assessment as to where we are now and what the debilitating impact will be if left to run on its own course, on the course without a change in direction.

So I'd be interested in getting the Comptroller's response. Thank you, Mr. Chairman.

The CHAIRMAN. Very good, Senator D'Amato.

Senator Shelby.

OPENING STATEMENT OF SENATOR SHELBY

Senator SHELBY. Thank you, Mr. Chairman. I'll try to be brief.

The recent decision by the FDIC to raise deposit insurance premiums by the largest increment in history, I believe is a loud signal that all is not well in the banking industry.

The General Accounting Office—you, sir—you paid an ominous picture of the condition of the banking industry that we thought was that way, but hoped wasn't.

You also in your testimony, you remind this committee that some of GAO's most important recommendations were not included in the FIRREA legislation.

I look forward to your testimony. I think there's a feeling all over America after the thrift industry that maybe it's going to run over into the banking and the FDIC fund and they see how thinly capitalized that fund is and the taxpayer knows what comes after the FDIC fund has run out.

I look forward to hearing your testimony.

The CHAIRMAN. Thank you.

Senator Sanford.

OPENING STATEMENT OF SENATOR SANFORD

Senator **Sanford**. Well, thank you very much. And I thank GAO for their usual good work. I for one am pleased that GAO is looking at this and I hope that you keep on looking at it and that we take whatever additional steps are needed to make certain that we don't let the same thing happen.

I saw a disturbing ad in—I think it was the New York Times, but a paper over the weekend advertising $100,000 insured certificates of deposit, reminiscent of the kind of ads you saw for the S&L's.

I think we need to be very prompt this time because there are, as Senator Graham pointed out, too many parallels, including the parallel of raising the premiums and adding a little bit to the fund as we did for S&L's, thinking in terms of a few billion to find out that it was of a much larger magnitude.

So we simply don't want to get caught again. I thought this was very good testimony that you filed, and the recommendations are very good. But I would hope that GAO would give its attention to the proposed legislation that we have now being generated here.

I particularly think that we've got to look at the limits, at the limits both in the amount insured and the amount that can be insured, the total amount, whether it's some limit to be put on the total amount or the specific deposit, somewhere in between.

We certainly are considering legislation of that kind.

We need also, it seems to me, the authority for FDIC to do what an insurance company could do, and that is to look at its underwriting risk and make two or three judgments, one of which would be not to insure that bank or to withdraw the insurance, which would be a drastic step and certainly would bring to an end more quickly that banking institution, but it also would minimize risk which now we have to wait out to a point when the losses are considerably greater.

There's certainly a danger in withdrawing insurance. But the threat of withdrawing insurance might very well bring about more sound banking practices.

So some kind of prompter action on the part of FDIC to protect its risk I think is necessary.

And also, I would hope that GAO might help us by commenting on the concept of "Too big to fail." I've always thought that that was simply not a sound policy. I see the arguments, but I've never felt that anyone examined adequately the alternatives.

Suppose we let it fail. Would we not be in a better position than if we took the position that something's too big to fail.

I would hope that we could get your views on that as we move along into this period of trying to make certain that we've done everything we can do from a legislative point of view.

And I thank you very much for what you have done.

[The complete prepared statement of Senator Sanford follows:]

Prepared Statement of Senator Sanford

Thank you, Mr. Chairman. I would like to thank you for calling for this hearing and to thank particularly Comptroller General Bowsher and his staff for their excellent work in preparing this audit. I have long admired Mr. Bowsher and the GAO for their fine, honest work. I must admit, however, that this morning's report is a hard one to face. As we all know, the GAO has issued their annual report on the soundness of the Bank Insurance Fund, which is the insurance fund for the deposits in every bank in the country. The bottom line of that report is bad news: "The fund is too thinly capitalized to deal with the potential for bank failures in the event of a recession."

Among the things stated in the GAO's audit are:

1. That not since its birth during the Great Depression has the commercial bank deposit insurance system faced such a period of danger and uncertainty.

2. That the ratio of insurance in the fund per insured deposits is at its lowest rate in history, a rate of only .7 percent of funds per total insured deposits.

3. That at least 35 large banks have been identified which are in such severe financial condition that, without some form of recapitalization, they are likely to fail or require assistance within the next year; and

4. That while the Congress required that by 1995 the fund achieve a minimum reserve ratio of 1.25 percent funds in per insured deposits, the FDIC and the GAO's predictions make it clear that the prospect for reaching that minimum level are not at all good.

I am extremely concerned about the implications of this report. I believe it is eerily reminiscent of reports we heard 4 and 5 years ago regarding the thrift crisis. Despite such reports, the administration, including Danny Wall, who was then the chief regulator for thrifts, told us not to worry, that the FSLIC has sufficient funds to handle the S&L problems. We have all seen how wrong it was to believe the administration's reports that the Congress did not need to take action.

I see this GAO audit as a call for action. I do not believe that we should let the 101st Congress adjourn before we take all the steps necessary to ensure that a crisis like that of the S&L's does not occur in the banking industry. I think we can and ought to implement some of the recommendations in this report, including: (1) action to ensure that onsite inspections take place for every troubled bank and every large bank on at least an annual basis; (2) that the FDIC is given the authority it needs to set bank insurance premiums at the level needed to ensure adequate reserves in the fund without placing an undue burden on the banks, and (3) that we take steps through the accounting profession and the banking regulators to ensure that losses are not concealed in appraisals and accounting entries that mask the true size of the problem.

While these changes in and of themselves will not eliminate the problems facing our banks or the FDIC, they are certainly reasonable measures that could be enacted now in order to stave off greater problems down the road.

The Banking Committee also needs to consider the broader implications of deposit insurance. I support the efforts of my colleague from Illinois, Senator Dixon, to craft a deposit insurance system that bases its premiums on the riskiness of the activities of the bank. If a bank engages in riskier activities, it ought to pay more in deposit insurance premiums. I also hope we will soon examine whether cutbacks in the scope of insurance coverage are appropriate, as well as steps that can be taken to make our banks more competitive and more profitable.

The GAO has sounded the clarion call for action before the FDIC fund comes close to insolvency. I intend to do all that I can to ensure that we heed that call and that the necessary steps are taken to shore up the FDIC now.

The CHAIRMAN. Thank you, Senator Sanford.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning to hear my friend, the Comptroller General, Charles Bowsher, discuss the General Accounting Office's audit of the Bank Insurance Fund.

I've had a chance to review his testimony and I think the Comptroller General's work and analysis represents a real public service. The testimony, of course, contains a lot of bad news. But this is not the thrift situation. We are not already facing an inevitable large-scale taxpayer liability.

There is still time to act.

I think the GAO testimony is in fact a call to action, Mr. Chairman. I believe we should act promptly and decisively.

At this time, I'd like to comment on three aspects of the Comptroller General's statement.

First, the statement points out that the FDIC's Bank Insurance Fund will likely not be able to achieve its 1.25 percent target ratio in the next 5 years. The FDIC, to its credit, has already begun to respond.

Bank deposit insurance premiums will rise next year to 19½ basis points, up from 12 points this year. That increase will bring in about $5 billion to the Bank Insurance Fund.

However, more, of course, needs to be done. We need to insure that the FDIC always has enough cash on hand to close institutions that need to be closed. We can't afford to let the insurance fund decline to levels that will create incentives for the FDIC to wait to close money-losing, insolvent institutions. We know now where that leads.

Second, the GAO calls for annual, on-site audits of every depository institution. Good. I want the Comptroller General to know that I agree with him on this point.

The deposit insurance reform legislation that I'll shortly introduce contains such a mandate. The risk-based deposit insurance bill that I'll be introducing in the next several days includes as part of that annual, on-site audits of every single deposit institution in the country.

Nothing more important than that, in my opinion, may I say to my good friend, the Comptroller General.

Third, I want Comptroller General Bowsher to know that I also agree that the bank regulators need better information on management controls and on the real risk of loss. That's why the legislation that I'll be introducing contains provisions that will guarantee that the regulators know about how good management systems are, now good loan documentation is, and what kinds of loans are being made.

There's a lot to be done, Mr. Chairman. I congratulate the Comptroller General for making a very substantial contribution to the reform debate in his testimony here this morning. And I look forward to working with him and all of my colleagues to ensure that essential reforms are quickly enacted.

I thank the Chair.

The CHAIRMAN. Thank you very much, Senator Dixon.

I just want to say one other thing before you start, Mr. Bowsher. And that is, the general picture out there in our economic and financial system shows us a number of things that are disturbing.

We've had a collapse in the savings and loan system, and that's well known to us. We have some problems in the banking system that your testimony today reveals. We've seen a major erosion in real estate values pretty much across the country, in some areas more so than others. We're seeing some contraction in the economy. We've seen the junk bond market go through a major downward revaluation. And we've seen some tremors in the stock market. The stock market is still holding up reasonably well at the present time. And there are other things that might be cited.

But taken together, I think there is a picture of great economic and financial stress out there in various parts of our system.

The banking system is crucial because it is the payment system. It's the way we move credit through the economy. And it's very important that safety and soundness and public confidence be maintained. If it needs treatment, it cannot be allowed to go on without treatment.

And so, we want your most candid assessment of the situation, your most pointed recommendations, and any thoughts beyond today. If steps are needed, this committee wants to take them at the earliest moment and not stand by and see ourselves overtaken by events.

So, with that, we welcome your comments at this time.

STATEMENT OF CHARLES A. BOWSHER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY DONALD H. CHAPIN, ASSISTANT COMPTROLLER GENERAL, ACCOUNTING AND FINANCIAL MANAGEMENT ISSUES, GAO; ROBERT W. GRAMLING, DIRECTOR, CORPORATE FINANCIAL AUDITS, GAO; AND GREGORY M. HOLLOWAY, ASSISTANT DIRECTOR, CORPORATE FINANCIAL AUDITS, GAO

Mr. **Bowsher**. All right. Thank you very much, Mr. Chairman, and members of the committee.

I'm accompanied here today by Mr. Chapin on my right, who is the Assistant Comptroller General for all our financial and accounting work. And Mr. Gramling on my left, who is the issue area director of the bank audits that we are doing. And Greg Holloway, who was in charge of this particular audit.

We're very pleased now to report to you the results of our 1989 audit of the Bank Insurance Fund.

I wish the message was more optimistic, but I think, as the members of the committee have pointed out, we have to today face the facts and be candid on what our problems are.

The first major point—and what I plan to do, Mr. Chairman, is just summarize the first four pages of my statement, and if the rest of my statement could be put into the record, I would appreciate that.

The **Chairman**. Very good. We'll make it a part of the record.

Mr. **Bowsher**. Along with the report itself.

The **Chairman**. Very good.

Mr. **Bowsher**. The first main point, of course, is what has happened to the fund balance? It has decreased 28 percent over the last 2 years, from $18.3 billion to $13.2 billion. The fund lost $4.2 billion in 1988 and $852 million in 1989.

The FDIC and its Chairman, Bill Seidman, now believe that the fund could suffer a third consecutive loss, as high as $2 billion, in 1990, due to the continuing high level of bank failures.

GAO did a special review this past year as we performed this audit. We looked at the 200 largest problem banks and the Nation's hundred largest banks, and when we did that review, we saw about 35 banks in such severe financial condition that without some form of recapitalization, they are likely to fail or require assistance within the next year.

We estimate that these banks, if they do fail, and some already have in 1990, will cost the fund between $4.4 billion and $6.3 billion. Those estimates are based on the historic factors that the FDIC uses.

We are concerned that the fund's cash resources are too low to enable it to deal decisively with problem banks. The fund faces potential cash shortages from its commitment to purchase troubled assets from acquirers of failed institutions.

As of December 31, 1989, the fund had $13.7 billion in cash and investments, but was contingently liable for about $8 billion of troubled assets acquirers may pass back to FDIC.

Our concern is the low level of cash resources coupled with existing commitments to purchase problem assets could limit FDIC's options for resolving future bank failures.

Now if I could just explain this a little more in detail. What happened was that when some of the larger banks in Texas had to come to the FDIC for assistance, instead of paying out a straight pay-out, you might say, they really set up what is known as separate asset pools at each of these banks. The assets were written down.

So the fund has taken the hit as far as what is the cost of these write-downs. But the assets were never transferred over at the reduced amount.

So that when the banks, which have the right to show up some day, and the agreements kind of go to 1993, roughly—some maybe into 1994. But you can see in the next 2 to 3 years, these new banks literally can show up here and present these separate asset pools and literally ask for cash in return.

So you have potentially out there some figure—it might be $8 billion, it might be higher, it might be somewhat lower—of a demand literally on the fund's cash. So this is a very significant feature that I would like everybody to understand and it's not as easily understood as what the equity balance is.

Now another concern related to the fund's commitment to purchase troubled assets from acquirers of failed institutions is that the estimated recoverable value of the assets may not be realized.

Overstated appraisal values for foreclosed real estate held by the acquirers could lead to additional losses to the fund. A sample of real estate with book values of $488 million showed an overstatement of about $76 million.

What we did here is we went out and looked at one of these major separate asset pools, the largest one, and that's where we saw that some of the assets were overappraised and overvalued. So what we're trying to do is to alert everybody to the fact that some of these assets probably are not worth quite as much as they're being carried at, on the books.

Now the next point I think is the major point. At year-end 1989, the ratio of the fund's balance to insured deposits reached its lowest point ever—0.7 percent. The prospect for the fund achieving the minimum reserve ratio of 1.25 percent by 1995, as designated by the Financial Institution's Reform, Recovery Enforcement Act of 1989—generally known as FIRREA—is not good.

Further, there appears to be no empirical or analytical basis for this 1.25 percent minimum reserve ratio. Therefore, we are concerned that even if the minimum reserve ratio could be achieved, it might well not be sufficient to protect the taxpayers in the event of a recession.

Over the next few years, low levels of reserves, coupled with a recession, could lead to a level of bank failures that would exhaust the fund and require taxpayer assistance.

I think this is the biggest concern, the biggest worry that we're presenting to you today.

Increased risks in the commercial banking industry are a major exposure to the fund's outlook. In 1989, problem banks remained at an alarmingly high number—about 1,100 or 9 percent of the industry.

Also, industry earnings declined $8.5 billion due to losses experienced by banks in the northeast and large commercial banks as a result of loss provisions for real estate and less developed country loans.

In addition to these concerns, the 50 largest bank-holding companies reported $126 billion of loans characterized as highly leveraged transactions. The performance of these risky loans and their ultimate effect on the financial condition of the banks is unknown because of their relative newness.

While the commercial banking industry's loan portfolio risks have increased, there has been relatively no change in the level of the industry's equity capital which, of course, is its cushion to absorb losses on loans.

We believe that regulators need a more timely, early warning of troubled institutions to minimize losses to the insurance fund. The quarterly reports of financial condition that banks prepare for the regulators do not always reflect their true financial condition. This may reduce the effectiveness of off-site monitoring by the regulators.

We are concerned that accounting principles allow bank management too much discretion in recognizing and determining loss amounts as reported in the financial statements.

If I could illustrate this point, using our recently completed audit of the Bank Insurance Fund as an example. In rendering our opinion, we concluded that the fund's financial statements were in conformity with generally accepted accounting principles despite the fact that we identified 35 banks in such severe financial condition that they are likely to fail within the next year—in fact, some already failed in the early part of 1990. The question is, should the costs associated with these failures have been booked on the fund's financial statements for fiscal year 1989?

By generally accepted accounting priniciples, because they were not considered a known loss, which has become the definition of the probable requirement for booking losses per accounting standards, they were not required to be booked.

We're concerned that deferral of loss recognition is pervasive in the Nation's financial system. And that's one of the things we're saying has to be relooked at by the accounting profession, the standard-setters—a more realistic standard and the interpretation of that standard so that we're not kidding ourselves about the adequacy of loss reserves and the financial condition of the industry.

So I think this is a very important issue.

The last point I'd like to make here is that our ongoing review of a number of banks that failed in 1988 and 1989 showed that serious internal control weaknesses contributed to their failure.

We previously reported this problem in 1989 for banks and savings and loans that failed in 1987 and made recommendations for improving their internal controls. Unfortunately, to the detriment of the insurance funds and the taxpayers, these recommendations were not included in the FIRREA legislation of 1989.

These improvements, along with a number of other auditing and financial reporting reforms, are critically needed to protect the deposit insurance funds in the future.

Now, I might point out, as some of you have already pointed out, that the FDIC, under Chairman Seidman's leadership, has recognized that the Bank Insurance Fund is too thinly capitalized in light of the exposures it faces. One of the reasons is that we had shared this report with them and so they were aware of our concerns and what we were finding.

So within the constraints of the FIRREA assessment provisions, they have proposed to increase the 1991 assessment rates. We commend the FDIC's timely action. However, additional steps are needed to minimize the potential costs facing the fund.

That, Mr. Chairman, I believe summarizes the most important issues arising from our work and we'd be very happy to answer any questions that you or any of the committee members have.

[The complete prepared statement of Charles A. Bowsher follows:]

United States General Accounting Office

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Additional Reserves and Reforms are Needed to Strengthen the Bank Insurance Fund

Statement of
Charles A. Bowsher
Comptroller General of the United States

Before the
Committee on Banking, Housing, and Urban Affairs
United States Senate

GAO Form 100 (12/87)

ADDITIONAL RESERVES AND REFORMS ARE NEEDED TO STRENGTHEN THE BANK INSURANCE FUND

TESTIMONY OF CHARLES A. BOWSHER
COMPTROLLER GENERAL OF THE UNITED STATES

BEFORE THE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

TUESDAY, 10:00 a.m., SEPTEMBER 11, 1990

Not since its birth during the Great Depression has the federal system of deposit insurance for commercial banks faced such a period of danger and uncertainty as it does today. Issues arising from our audit of the Bank Insurance Fund's 1989 financial statements, the report on which is being issued today, cause us both apprehension and concern for the safety and soundness of the Fund in the 1990s.

The Fund reported a loss of $852 million in 1989, its second consecutive loss, which reduced the Fund balance to $13.2 billion. The record level of bank failures that occurred during the last two years has reduced the Fund's ratio to insured deposits to only .7 percent at December 31, 1989, its lowest level in the Fund's history. FDIC now believes the Fund could suffer another loss as high as $2 billion in 1990, due to the high level of bank failures that is continuing in 1990.

The increasingly risky nature of the industry's loan portfolio is resulting in increasing loan performance difficulties which could severely impact the Fund. We have identified 35 large banks in such severe financial condition that without some form of recapitalization, they are likely to fail or require assistance within the next year. We estimate that these banks, if they fail, will cost the Fund between $4.4 billion and $6.3 billion. We also identified a significant number of other institutions that were experiencing severe negative performance trends.

The prospect for the Fund achieving the minimum reserve ratio of 1.25 percent by 1995 as designated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) is not good. Neither FDIC's nor our projections of the Fund balance indicate that the Fund can achieve the desired minimum reserve ratio under the current assessment provisions in FIRREA. In fact, over the next few years, the Fund's low reserve level accompanied by a recession could lead to a level of bank failures that would exhaust the Fund and require taxpayer assistance.

Our audit raises other concerns, including

-- the low level of cash resources coupled with existing commitments to purchase problem assets from acquirers of failed banks, which will limit FDIC's options for resolving future banks failures,

-- overstated appraised values for foreclosed real estate held by acquirers of failed banks that can be passed back to FDIC could lead to additional losses to the Fund,

-- accounting and reporting by banks, which is not providing regulators with an adequate early warning of financial problems and may reduce the effectiveness of off-site monitoring by regulators. Application of generally accepted accounting principles allow too much discretion on the part of bank management and may be unduly delaying the recognition of losses in the financial statements, and

-- serious internal control weaknesses that contributed to the failure of a number of banks in 1988 and 1989. We cited similar problems in banks and savings and loans in previous reports and made recommendations for improving their internal controls. Unfortunately, to the detriment of the insurance funds and the taxpayers these recommendations were not included in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. These improvements along with a number of other auditing and financial reporting reforms are critically needed to protect the deposit insurance funds.

The Bank Insurance Fund is too thinly capitalized in light of the exposures it faces. FDIC has recognized this and, within the constraints of FIRREA's assessment provisions is proposing to increase the 1991 assessment rates. We commend FDIC's timely actions, however, additional steps are needed to minimize the potential liabilities facing the Fund. We encourage the Congress, regulators, the accounting profession, and others to implement the recommendations in our report which we believe are needed to minimize losses to the Fund. We must do everything possible to ensure that the banking industry avoids the debacle that consumed the savings and loan industry and is now costing the nation's taxpayers hundreds of billions of dollars.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the results of our audit of the Bank Insurance Fund's 1989 financial statements. The report on our 1989 audit[1] is being issued today, and it addresses in detail the issues we will discuss. The message is disturbing.

-- The Fund balance has decreased 28 percent over the last 2 years from $18.3 billion to $13.2 billion. The Fund lost $4.2 billion in 1988 and $852 million in 1989. FDIC now believes the Fund could suffer a third consecutive loss as high as $2 billion in 1990, due to the continuing high level of bank failures.

-- Our review of the 200 largest problem banks and the nation's 100 largest banks showed 35 banks in such severe financial condition that without some form of recapitalization, they are likely to fail or require assistance within the next year. We estimate that these banks, if they fail, will cost the Fund between $4.4 billion and $6.3 billion.

-- We are concerned that the Fund's cash resources are too low to enable it to deal decisively with problem banks. The Fund faces potential cash shortages from its commitment to purchase troubled assets from acquirers of failed institutions. As of December 31, 1989, the Fund had $13.7 billion in cash and investments but was contingently liable for about $8 billion of troubled assets that acquirers may pass back to FDIC. Our concern is the low level of cash resources coupled with existing commitments to purchase problem assets could limit FDIC's options for resolving future bank failures.

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[1] Bank Insurance Fund: Additional Reserves and Reforms Needed to Strengthen the Bank Insurance Fund (GAO/AFMD-90-100, September 11, 1990).

-- Another concern related to the Fund's commitment to purchase troubled assets from acquirers of failed institutions is that the estimated recoverable value of the assets may not be realized. Overstated appraisal values for foreclosed real estate held by the acquirers could lead to additional losses to the Fund. A sample of real estate with book values of $488 million showed an overstatement of about $76 million.

-- At year-end 1989, the ratio of the Fund balance to insured deposits reached its lowest point ever, .7 percent. The prospect for the Fund achieving the minimum reserve ratio of 1.25 percent by 1995 as designated by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) is not good. Further, there appears to be no empirical basis for the 1.25 percent minimum reserve ratio. We are concerned that even if the minimum reserve ratio could be achieved, it would not be sufficient to protect the taxpayers in the event of a recession. Over the next few years, low levels of reserves coupled with a recession could lead to a level of bank failures that would exhaust the Fund and require taxpayer assistance.

-- Increased risks in the commercial banking industry are a major exposure to the Fund's outlook. In 1989 problem banks remained at an alarmingly high number, about 1,100 or 9 percent of the industry. Also, industry earnings declined $8.5 billion due to losses experienced by banks in the Northeast and large commercial banks as a result of loss provisions for real estate and less-developed country loans. In addition to these concerns, the 50 largest bank holding companies reported $126 billion of loans categorized as highly leveraged transactions. The performance of these risky loans and their ultimate effect on the financial condition of banks is unknown because of their relative newness. While the commercial banking industry's loan portfolio risks have increased, there has been relatively no change in the level of the industry's equity capital, its cushion to absorb losses on loans.

-- Regulators need a more timely early warning of troubled institutions to minimize losses to the insurance fund. The quarterly reports of financial condition that banks prepare for the regulators do not always reflect their true financial condition, and this may reduce the effectiveness of off-site monitoring by regulators. We are concerned that accounting principles allow bank management too much discretion in recognizing and determining loss amounts as reported in financial statements.

-- Our ongoing review of a number of banks that failed in 1988 and 1989 showed that serious internal control weaknesses contributed to their failure. We previously reported this problem in 1989 for banks and savings and loans that failed in 1987 and made recommendations for improving internal controls. Unfortunately, to the detriment of the insurance funds and the taxpayers these recommendations were not included in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989. These improvements along with a number of other auditing and financial reporting reforms are critically needed to protect the deposit insurance funds.

FDIC has recognized that the Bank Insurance Fund is too thinly capitalized in light of the exposures it faces and, within the constraints of FIRREA's assessment provisions, is proposing to increase the 1991 assessment rates. We commend FDIC's timely actions, however, additional steps are needed to minimize the potential liabilities facing the Fund. I would now like to provide some of the details of the issues facing the Bank Insurance Fund along with my recommendations.

PROBLEM BANKS EXPOSE THE BANK INSURANCE FUND TO SIGNIFICANT RISKS

The Bank Insurance Fund enters the 1990s in a precarious position. Between 1980 and 1987, the ratio of the Fund balance to insured deposits averaged 1.17 percent. At December 31, 1989, however, the ratio of the Fund balance to insured deposits equaled .7 percent, the lowest this ratio has ever been in the history of the Fund. Clearly the past 2 years have seen a significant deterioration of the Fund at a time when its exposure to potential, significant losses is higher than ever. At December 31, 1989, FDIC identified 1,109 banks with assets of $235 billion as problem institutions. The number of problem banks continues to be high and poses a significant financial threat to the health of the Bank Insurance Fund.

As part of our financial audit, we analyzed the financial condition and performance of 300 banks. These included banks with assets in excess of $100 million on FDIC's December 31, 1989, problem bank list, the 100 largest commercial banks in the United States, and other institutions that we identified as problem banks based on regulatory and public source information. Our analysis focused on large banks because experience has shown that large bank failures cause the most significant impairment of the Fund.

Based on our analysis, we identified 35 banks that were in such severe financial condition at December 31, 1989, that without some form of recapitalization they are likely to fail or require regulatory assistance within the next year. These banks are located principally in the Northeast and Southwest and had assets totaling $45.1 billion at year-end 1989. Generally, these 35 banks had regulatory capital comprised primarily or only of loss reserves, were insolvent based on equity capital[2] or had minimal levels of equity capital, had excessive and increasing levels of problem assets, and had negative earning trends that, if continued, would result in their failure. Using FDIC's historical loss rates, we estimate that the cost to the Fund for the failure of all 35 banks would be between $4.4 billion and $6.3 billion. Because the FDIC historical loss rates do not reflect the major changes in the composition and quality of the industry's loan portfolio, our cost estimates could be significantly understated. The following table shows key financial indicators for the 35 troubled banks compared to other banks in our sample and the industry.

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[2] The major distinction between equity capital and regulatory capital is that reserves for loan and lease losses are included in regulatory capital.

Key Banking Industry Financial Indicators as of December 31, 1989

(dollars in billions)

	Total	Equity Capital		Problem Assets		Net Income (Loss)	
	Assets	Amount	Percent[a]	Amount	Percent[a]	Amount	Percent[a]
Problem banks (35)	$ 45.1	$ .6	1.4	$ 4.0	8.8	$ (1.6)	(3.5)
Total sampled banks (300)	1,999.9	100.1	5.0	79.1	4.0	1.7	.1
Total commercial banks (12,706)	3,299.0	206.0	6.2	113.8	3.4	16.3	.5

[a] Percentage of total assets

As of August 13, 1990, 15 of the 35 banks had failed.

In addition to these 35 banks, we identified a significant number of other large banks that were experiencing severe negative performance trends as of December 31, 1989. While their financial condition was not as severe as that of the 35 banks, these other banks are at risk to fail within the next few years, particularly if their regional economies continue to deteriorate. These banks are also located principally in the Northeast and Southwest. If both these banks and the 35 other banks were to fail, the Fund could be severely impaired. A recession could exacerbate this problem, causing failure of other large banks beyond those we have identified, exhausting the Fund, and resulting in a taxpayer bailout.

SEPARATE ASSET POOLS ARE A POTENTIAL CASH PROBLEM

In addition to the exposures that could severely impact the Fund's equity condition, a number of existing failure and assistance transactions pose a potential future drain on the Fund's cash resources. In the last few years, FDIC has entered into agreements with the acquirers of failed institutions which under certain limits require FDIC to purchase from the acquirers an undetermined portion of the failed banks' remaining troubled assets that are maintained and reported as separate asset pools by the acquiring banks. At December 31, 1989, the Fund's potential cash exposure for assets held in separate asset pools was about $8.0 billion. We believe that FDIC needs to ensure that these transactions are carefully monitored to avoid cash availability problems for the Fund and to prevent overextending the Fund's cash resources.

A related concern is that unrealistically high appraised values could mask losses that the Fund may incur when assets held in separate asset pools are sold. These assets are recorded and adjusted based on appraised values, in accordance with FDIC guidelines. If appraisals are based on unrealistic assumptions, the assets' appraised and recorded value may not reflect what FDIC could recover at their disposition. During our review of the largest of the three separate asset pools, we estimated that the book balances of $488 million for the other real estate owned that was acquired through foreclosure were overstated by about $76 million. We believe the FDIC should revise its guidelines for recorded values of assets held in separate asset pools. The underlying assumptions used by appraisers in valuing assets should be reviewed and recorded values adjusted when appraiser assumptions are not based on the assets' historical experience and current conditions.

OUTLOOK FOR THE BANK INSURANCE FUND

The outlook for the Bank Insurance Fund is dependent on its ability to maintain a sufficient level of capital to cope with the exposures it faces. FIRREA provides for FDIC to charge incrementally increasing annual assessment rates to insured commercial banks beginning in 1990. FIRREA also authorizes FDIC to increase these prescribed rates if the ratio of the Fund's balance to insured deposits is expected to decline, but limits annual increases and stipulates an assessment rate ceiling. FDIC recently proposed to increase the annual assessment rate to .195 percent for 1991, the maximum increase allowable, because it expects a loss in 1990 which will reduce the Fund balance and its ratio to insured deposits.

We commend FDIC's actions. We believe, however, that the proposed rate increase will not be sufficient to restore the Fund's capital position to a level adequate for it to deal with large bank failures that could occur in a recession. Both our projections of the Fund's ratio to insured deposits and those of FDIC illustrate that it is unlikely that the Fund will achieve the designated reserve ratio of 1.25 percent by 1995 under the current constraints of FIRREA, even in a non-recessionary environment.

Ratio of the Fund Balance to Insured Deposits (Percent)

	1989 (Actual)	1990	1991	1992	1993	1994	1995
FDIC - Scenario 1	0.70	0.74	0.82	0.91	1.00	1.11	1.22
FDIC - Scenario 2	0.70	0.66	0.67	0.69	0.72	0.76	0.81
GAO - Scenario 1	0.70	0.74	0.82	0.89	0.95	1.01	1.07
GAO - Scenario 2	0.70	0.61	0.74	0.82	0.89	0.95	1.02
GAO - Scenario 3	0.70	0.58	0.63	0.64	0.65	0.67	0.69

The key distinction between the five scenarios is the assumptions regarding the level of bank failures and their cost to the Fund. Under FDIC's first scenario, failure and assistance expenses are assumed to equal the average actual costs incurred by the Fund over the last ten-years. Under FDIC's second scenario, these costs are estimated based on actual costs for the last five years, the time period where the Fund incurred the majority of its costs. The FDIC scenarios do not reflect the recent statements made by the Chairman that the Fund could incur a net loss for 1990 and do not reflect FDIC's recent proposal to increase the 1991 assessment rate. FDIC has not revised its projections to account for the estimated loss in 1990 and the proposed assessment rate increase for 1991.

Our projections assume differing levels of bank failure and assistance expenses in increasingly more severity based on banks that we believe will fail soon and over the next few years if their negative financial trends persists. Additionally, under all three of our scenarios, we applied the maximum allowable assessment rates to derive assessment income. Despite this, none of our projections indicate that the Fund has the ability to achieve the minimum reserve ratio of 1.25 percent by 1995 under the current assessment provisions of FIRREA.

Our projections illustrate significant potential losses facing the Fund in the 1990s. I should also note that both our projections and those of FDIC assume a stable economy. A recession or a severe decline in the Northeast economy similar to what occurred in the Southwest could result in additional large banks failing beyond those included in our estimates. Also, the banking industry's increased dependence on riskier assets could result in additional losses and bank failures. For example, based on FDIC's historical loss rates, a $13 billion Fund balance could be eliminated by the costs related to the failure of one or more large money center banks with total assets of $130 billion. While

I am not saying that any money center banks are currently in danger of failing, this example demonstrates the vulnerability of the Fund at its current level of reserves.

We did not identify any study done to set the minimum (1.25) and maximum (1.50) reserve ratios prescribed by FIRREA. For this reason, and because of our concerns about the potential exposure facing the Bank Insurance Fund, we believe the Secretary of the Treasury's study of deposit insurance reform required by FIRREA needs to examine the reasonableness of these minimum and maximum reserve ratios. We believe this study needs to propose a reserve ratio target that regulators believe would protect taxpayers in the event of a recession.

We recognize the concern that raising assessments to build a more adequately capitalized Fund could significantly impact the profitability and competitiveness of banks. Also, achieving adequate protection for the Fund and ultimately the taxpayer solely through assessment premiums may not be feasible. Therefore, as part of the deposit insurance reform study, we believe the Department of Treasury should assess banks' ability to pay higher premiums and estimate at what point such higher premiums may become counter productive in their benefit to the Fund. Treasury's study should also consider other means for reducing the Fund's exposure such as bank capital levels required to be maintained and other

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options that would further protect the Fund and ultimately the taxpayers.

While the studies of deposit insurance reform are being completed, we believe that FIRREA should be amended to give FDIC authority to raise rates beyond those provided in FIRREA. FDIC should use this authority to achieve the minimum reserve ratio of 1.25 percent designated in FIRREA by 1995.

COMMERCIAL BANKING INDUSTRY CONDITIONS THAT COULD LEAD TO MORE BANK FAILURES

The commercial banking industry's performance in 1989 and outlook add to our concerns for the safety of the Bank Insurance Fund. Industry earnings declined $8.5 billion from their 1988 level of $24.8 billion, to $16.3 billion. The large decline in earnings in 1989 is attributable to banks in the Northeast and the large commercial banks with assets in excess of $10 billion.

Real estate lending, which has increased significantly as a percentage of total industry lending activity, has experienced increasing loan performance difficulties. The Northeast in particular has experienced significant growth in nonperforming real estate loans. While total outstanding real estate loans in the Northeast increased 12 percent, from $232 billion in 1988 to $259 billion in 1989, the level of these loans that were nonperforming increased from $4 billion in 1988 to $10 billion in 1989. This trend in the Northeast is reminiscent of the growth in noncurrent real estate loans in the Southwest during the early 1980s that eventually led to the high level of bank failures in that region from the late 1980s to the present. These failures caused the dramatic deterioration of the Fund over the last 2 years.

I am also concerned about the impact LDC loan difficulties are continuing to have on the industry. The level of U.S. commercial bank exposure on troubled foreign loans has declined from $91 billion in 1982, the beginning of the international debt crisis, to $54 billion at year-end 1989. The remaining exposure, however, is heavily concentrated in nine money center banks. These banks held $43 billion (80 percent) of the nation's troubled foreign loans at December 31, 1989. These banks currently have reserves averaging 49 percent of their foreign loan exposure. We are concerned that continued high LDC losses could make some of these banks more susceptible to failure.

The industry also faces growing risks from its increasing levels of loans considered highly leveraged transactions (HLTs). During the 1980s, HLT loans experienced significant growth with the advent of the junk bond market in the investment banking industry. The high debt to equity ratio typically present in companies involved in HLTs reduces the banks' likelihood of recovering in the event of default. The commercial banking industry's exposure on

HLTs is generally in the form of secured, senior debt, with minimal junk bond exposure. The impact of loans categorized as HLTs on the cost of future bank failures is unknown. However, recent bankruptcy filings of companies involved in junk bond offerings demonstrate that there is a risk that the secured, senior debt portion of the original financing package may not be fully repaid. This could result in losses for commercial banks because the related loan collateral value may be significantly less than the outstanding loan balance remaining to be repaid.

RELIANCE ON BANK FINANCIAL REPORTS MAY HINDER EARLY WARNING OF PROBLEM BANKS

Another factor affecting the Fund's estimated exposure for future bank failures is the quality of quarterly call reports the banks prepare for the regulators. These reports, which are unaudited, are used by the bank regulators in their off-site monitoring of banks' financial condition and performance between on-site examinations. The reports are also used in helping to decide the frequency and timing of on-site bank examinations and generally in planning the scope of an on-site examination.

Although we did not review the overall quality of call reports, we have found examples in reviewing certain problem banks that suggest call report accuracy often depends on whether there has been a recent examination by the bank regulators. Generally, we found that the regulators reported that these institutions had understated the level of nonperforming loans in their call report submissions, and thus had established inadequate levels of loss reserves and had overstated interest income and net income.

Another indicator of the problems with the quality of call report data is the timing of bank failures in relation to when and if the bank appeared on FDIC's problem bank list. Because a bank's financial condition does not deteriorate overnight, the regulatory supervision process should detect an emerging problem bank prior to its imminent failure. Of the 406 banks that failed in the last 2 years, however, we found that 22 failed without ever appearing on the problem bank list and that 9 failed after appearing on the list for only one quarter. The absence or limited presence of these banks on the problem bank list suggests that the regulators had not thought them to be in danger of failing until the bank examiners, in conducting on-site examinations, found them to be in such severely deteriorated financial condition that they were immediately closed.

The Fund's potential exposure from large banks and known problem banks is so great that accurate, up-to-date information on their financial condition is essential. Additionally, the accuracy of call report data, particularly for troubled or near troubled banks where the effect of misstatement is more critical, is a concern for effective off-site monitoring. Therefore, we believe that the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Federal Reserve Board, and the Comptroller of the Currency should ensure that annual full scope, on-site examinations of all large banks and known problem banks are performed. We are currently reviewing the regulators' enforcement of bank capital standards. Further, because of our concerns, we plan to review the regulators' entire examination and supervision program beginning this fall.

ACCOUNTING AND AUDITING REFORMS NEEDED TO PROVIDE EARLY WARNING OF TROUBLED DEPOSITORY INSTITUTIONS

Regulators need more timely and reliable data on the financial condition of depository institutions to more effectively work with management to restore the health of troubled institutions and to minimize losses to the insurance fund. There is a concern that financial data prepared in accordance with generally accepted accounting principles are inadequate for this purpose. Call report data are accounted for and reported in accordance with generally accepted accounting principles. Banking regulations require that call reports be prepared on that basis.

Generally accepted accounting principles call for a writedown from cost to market value and recognition of a loss when an asset value has been diminished. But, there are major problems with the timing of the recognition of loss and the determination of the amount of the writedown.

- -- The requirement that a loss be "probable" before it is recognized. "Probable" is frequently interpreted in practice as "virtually certain." The "probable" requirement unduly delays the writedown of problem assets to fair market value and thus defers recognizing the loss in the financial statements.

- -- The definition of fair market value used in determining the amount of the loss to be recognized. The definition assumes that the asset can be held until market conditions are good and that the seller has a good bargaining position. This frequently results in higher fair market values than are justifiable in the circumstances.

These generally accepted concepts for recognition of loss and the determination of fair market value frequently result in sudden dramatic losses when banks get into trouble and the regulators require loss recognition on a realistic basis. These losses could have been reflected earlier in bank call reports under more stringent accounting rules and thus provided a more timely early warning of bank failures. We are currently reviewing whether limited changes in present cost based generally accepted accounting principles would be sufficient, or whether some form of market value accounting is necessary to provide more reliable call report data.

Our present view is that generally accepted accounting principles pertaining to the probability of collection of a troubled loan allow bank management too much leeway to defer the recognition of losses in financial statements. In our current work on bank failures we found a number of examples where examiners identified loans where collection was doubtful and in hindsight bank management should have recorded reserves to writedown the loans and recognize the losses. These loans were carried at historical cost because, based on bank management's judgment, the potential losses on these loans did not meet the accounting criteria of "probable" that would have required writedowns to fair value.

Similarly, our present view is that generally accepted accounting principles relating to fair market value do not sufficiently recognize the need for banks to realize collateral values in a short period of time. The traditional fair market value concept establishes values in a hypothetical market where the seller is under no compulsion to sell and has time to negotiate a sale. Assets in troubled banks and separate asset banks, or even nonperforming assets in any bank, may have to be and are often disposed of in a market when conditions require that the assets be disposed of within a short time frame.

Conceptually, accounting for bank failures and the related loss recognition has some of the same inherent weaknesses as accounting for loan losses. The Bank Insurance Fund's December 31, 1989, financial statements are fairly presented in accordance with generally accepted accounting principles. However, the estimated costs of $4 billion to $6 billion from the banks we believe are likely to fail in the near future unless recapitalized do not meet the degree of certainty for loss recognition established by accounting principles. Accordingly, these estimated losses are not recognized in the Fund's financial statements.

The Financial Accounting Standards Board is currently studying certain market value accounting and disclosure issues for financial institutions. We encourage the Board to address market value based accounting for financial institutions. Based on our ongoing study of these issues our preliminary view is that market value based accounting or, in the alternative, comprehensive market value disclosure, is preferable to present accounting and disclosure standards for financial institutions.

In the interim, it is important that certain limited changes be made to existing generally accepted accounting principles for nonperforming loans and other real estate owned acquired through foreclosure. The accounting profession should promptly consider amending accounting rules to require

-- recording losses when occurrence of loss is likely (more than a 50 percent chance) rather than "probable" as required under existing rules, and

-- valuing the underlying collateral on the assumption that near term disposition of the asset will be required.

We believe this interim step is needed to improve the early warning system and thereby help protect the Bank Insurance Fund.

I would now like to talk about auditing reforms that are needed to provide regulators an early warning of troubled banks. Before FIRREA was enacted, we reported that serious internal control weaknesses cited by federal regulators contributed significantly to virtually all of the 184 banks which failed in 1987.[3] We also reported that regulator's examination reports and related data showed numerous and sometimes blatant violations of laws and regulations at 26 failed savings and loans that we reviewed to determine the cause of their failure.[4] We recommended then that FIRREA include requirements for insured institutions to undergo annual financial audits and issue management reports on the effectiveness of internal controls and their compliance with safety and soundness laws and regulations. To provide assurance on the validity of the management reports, we also recommended that, as part of the annual audit, auditors be required to review and report on management's assertions contained in its reports. Unfortunately, these recommendations were not adopted by Congress in FIRREA.

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[3] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 31, 1989).

[4] Thrift Failures: Costly Failures Resulted from Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 16, 1989).

Weak internal controls are a serious problem in financial institutions which have recently failed and have contributed significantly to those failures. In studying the accounting and reporting issues I just discussed, we reviewed examination reports of 39 banks which failed in 1988 and 1989. Those reports showed that serious internal control weaknesses existed in many of the institutions. Bank management and the boards of directors have a responsibility to operate their institutions in a safe and sound manner. Safety and soundness relates not only to overseeing the day-to-day operations of the bank, but also to establishing and maintaining an effective internal control structure. The accounting profession and, of course, government regulators also play a significant role in ensuring corporate accountability. We need to ensure that these major players work well and that they work together.

I believe that when Congress revisits FIRREA, there should be amendments to include and strengthen the management and auditing reporting requirements we previously recommended. Also, these reporting requirements should be buttressed with other auditing reforms to provide regulators more timely and reliable information on the health of financial institutions. These additional auditing reforms include

-- Strengthening auditing procedures to require auditors to assess the risks and uncertainties affecting the institution's ability to continue as a going concern over the next year.

-- Strengthening the auditor's responsibility for detecting illegal acts and to ensure that these illegal acts are reported to the regulators when management has not dealt with the problem.

-- Requiring the regulators to share with the auditors their knowledge of potential illegal acts by institutions. Exceptions should be made for situations involving litigation and ongoing investigations.

-- Requiring insured depository institutions to have independent audit committees, which should include at least one attorney to help assure their institutions comply with laws and regulations.

Finally, I would add that the stakes are just too high for the regulators to be monitoring the condition of institutions using unaudited call reports, especially when the quality of those reports for problem institutions is suspect. We believe those reports should be reviewed by auditors for known problem institutions and those large institutions that, if they fail, would cause a significant loss to the insurance funds.

Our March 7, 1990, response to the Treasury's request for comments on issues under its study of the deposit insurance system and my August 2, 1990, testimony before the House Subcommittee on Telecommunications and Finance[5] contain a detailed discussion of my recommendations. I would request that copies of that letter and testimony be included in the hearing record.

CONCLUSIONS

All of the concerns we have discussed today paint a troubled picture for the future of the banking industry and the Bank Insurance Fund. They are all serious concerns. We have presented our concerns to encourage the Congress, regulators, the accounting profession, and others to implement the changes needed to minimize losses to the Bank Insurance Fund. We must do everything possible to ensure that the banking industry avoids the debacle that consumed the savings and loan industry and is now costing the nation's taxpayers hundreds of billions of dollars.

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[5] Prevention, Detection, and Reporting of Financial Irregularities, Statement of Charles A. Bowsher, Comptroller General of the United States, before the Subcommittee on Telecommunications and Finance, House Committee on Energy and Commerce (GAO/T-AFMD-90-27, August 2, 1990).

Mr. Chairman, this concludes my prepared statement. I would be pleased to answer any questions you or the members of this Committee may have at this time.

Comptroller General
of the United States

Washington, D.C. 20548

March 7, 1990

The Honorable Nicholas F. Brady
The Secretary of the Treasury

Dear Mr. Secretary:

This letter responds to the notice published in the Federal Register on December 6, 1989, in which you requested comments on the topics being addressed by the Department of the Treasury's study of the federal deposit insurance system. We are only commenting on the issues identified under the topic of auditing and on-site examination as they relate to banks and savings associations.

Under this topic, you requested comments on whether a closer relationship between the auditors and regulators of depository institutions would benefit the deposit insurance system. You also asked for comments on the feasibility of adopting regulations that are the same as, or similar to, the audit provisions of England's Banking Act of 1987. Overall, we support establishing a closer relationship between auditors and regulators and implementing regulations similar to many of the audit provisions in the Banking Act. We also believe that other improvements are needed to better ensure the safety and soundness of insured depository institutions.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) also requires us to study and report on deposit insurance issues and to conduct a comprehensive study of the credit union system. Our studies are currently in process.

Other work that we plan to complete this year will also address some of the other issues you raised. At the request of the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, House Committee on Banking, Finance and Urban Affairs, we are currently reviewing the condition of the Bank Insurance Fund and the banking industry. In addition, due to our concerns that current accounting requirements may not meet the regulators' needs, we recently started a study of bank accounting practices. Our purpose is to determine whether market value accounting would provide more useful disclosure of the true financial condition of banks.

GAO SUPPORTS MORE COMPREHENSIVE AUDITING AND REPORTING REQUIREMENTS

As you are aware, GAO has long been an advocate of and continues to strongly support audit and management reporting requirements. We believe that the management of all insured banks and savings associations should be required to issue reports assessing the effectiveness of their internal control structures and their compliance with laws and regulations related to safety and soundness. Further, all insured banks and savings associations should be required to undergo annual financial audits. Also, the role of auditors should be expanded to have them review and report on management's assertions contained in their report on internal controls and compliance. Our opinion on the need for management reporting and audit requirements is driven by three fundamental beliefs.

First, the federal government, as insurer of deposits, has a significant contingent liability to honor those deposits in the event of default. It therefore needs adequate mechanisms to protect its interests. FIRREA included many needed reforms, including strengthened capital requirements, limits on the activities of insured institutions, and strengthened supervision and enforcement. However, these reforms are not meaningful unless we ensure that institutions maintain strong internal controls, adhere to laws and regulations, and properly report their financial condition. Requiring management and audit reports would help fill a void in our current supervisory and examination structure. These requirements would also provide the federal government with a strong tool to help protect its interests.

Second, management of banks and savings associations have a fiduciary responsibility to operate their institutions in a safe and sound manner and protect the interests of their depositors. However, our work on the causes of savings association and bank failures showed that these failures were caused in large part by internal control weaknesses and noncompliance with laws and regulations directly within the control of management. This failure by management to fulfill its fiduciary responsibility for operating the institutions in a safe and sound manner occurred even though guidance, regulations, and directives were in place regarding their responsibilities. Requiring management to report to the regulators and deposit insurer on their responsibilities for establishing and maintaining an effective internal control structure, including controls for compliance with laws and regulations, and on the effectiveness of their internal controls would help ensure that controls are being maintained.

Third, we believe that the accounting profession has a responsibility to protect the government's and the taxpayers' interests when accepting an audit engagement of an insured depository institution. As such, the profession should take a proactive role in assisting institutions and the regulators to identify, prevent, and correct problems in financial reporting and internal controls. Regulators have come to increasingly rely on "off-site" monitoring using reported financial information. Therefore, it is imperative that this information be accurate and reliable. The accounting profession is in a unique position to help ensure the accuracy of this financial information. Further, expanding the role of auditors to require them to report on management's assertions on internal controls and compliance with laws and regulations is in keeping with our belief that the accounting profession has to assume greater responsibility than it currently has when accepting an audit engagement of an insured institution.[1] It would also help ensure the validity and reliability of the management report.

You have asked for comments on three specific proposals:

-- Requiring auditors to report audit results to the regulators,

-- Requiring regulators to share reports on an institution with its auditors, and

-- Requiring auditors to participate in conferences between the regulator and the institution.

In general, we support the general concepts of these three proposals. However, the full benefit of establishing a closer relationship between depository institution auditors and regulators will not be achieved unless all institutions are required to issue a management report as we have proposed on their internal controls and compliance with laws and regulations, and to undergo an annual financial audit. Consequently, in addition to establishing requirements that would allow a closer relationship between auditors and regulators, auditing and management reporting requirements for banks and savings associations should be implemented.

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[1] The accounting profession also has to assume greater responsibility when accepting an audit engagement of any public company. Our opinion on the need for management reports and an expanded role for auditors applies to public companies as well as insured banks and savings associations.

We have previously supported and continue to support requiring the results of any audit to be reported to the regulators. Such a requirement is already in place for savings associations and should be implemented for all insured depository institutions. We also believe that regulators' reports on institutions should be shared with the auditor. Although section 931(a) of FIRREA requires an institution to share audit and examination reports with its auditor, we would, with exceptions to cover sensitive situations, support regulations to specifically require regulators to share information with the auditor.

We generally support the concept of auditor participation in meetings between regulators and insured institutions. Such participation would help auditors better fulfill their audit responsibilities. It may also provide the regulator with additional perspective on issues being addressed. However, the responsibility should be on the regulator or the institution to request that the auditor attend meetings. Also, auditor participation in conferences should be balanced with appropriate protection for the auditor from liability for disclosing information which might otherwise contravene any duties to the client. Our detailed comments on the three issues are provided in Enclosure I.

Under the same topic, you also asked about specific provisions in England's Banking Act of 1987. We would support regulations similar to many of the specific sections in that act on which you asked for comment. We have previously supported many of the concepts raised in those sections, such as required audits of entities applying for federal deposit insurance coverage and direct notification by the auditor to the regulator if the auditor is removed or replaced, resigns, or does not seek reappointment.

Nonetheless, we have various concerns with adopting requirements and authorities similar to those contained in some of the Banking Act's provisions. For example, the institution's auditor of record should be appointed by the institution rather than the regulator. Also, any additional auditor responsibility to directly report information to the regulators should be balanced with appropriate protection from liability for the auditor.

In some cases, we have no comments on specific provisions of England's Banking Act other than to note that there currently are similar federal laws and regulations. Our detailed comments on each of the sections in the Banking Act are provided in Enclosure II.

OTHER RELEVANT ISSUES

Management reporting and audit requirements should go a long way toward preventing internal control weaknesses and noncompliance with laws and regulations. However, this belief is predicated on the quality of both management's assessment of internal controls and compliance with laws and regulations and the auditor's work, and on the auditor's independence. Our prior work on audit quality showed that certain steps should be taken to improve auditing and financial reporting. Many steps, such as revising and improving auditing standards, have already been taken. Some remain to be accomplished. In particular, two items should be considered as a means to ensure the quality and reliability of management and auditor reports.

First, insured depository institutions should be required to establish audit committees made up of outside directors. These directors should be independent in fact and appearance. As the Treadway Commission noted in its October 1987 report, audit committees can play an important role in preventing and detecting fraudulent financial reporting and overseeing internal controls. The audit committee should be responsible for appointing and reviewing the work of the auditor. As such, it would enhance auditor independence by serving as a buffer between management and the auditor.

The audit committee should include at least one attorney familiar with laws and regulations affecting insured institutions. Requiring an attorney to serve on the committee would provide a legal perspective on the application of laws and regulations and the relevant policies and procedures to achieve compliance.

Second, serious consideration should be given to requiring mandatory peer reviews for all auditors of insured depository institutions. Peer reviews serve as the cornerstone of the accounting profession's quality assurance program. They help ensure that auditors maintain high quality operations and adhere to professional standards. Although the American Institute of Certified Public Accountants (AICPA) has implemented a mandatory peer review program for its members in public practice, not all accounting firms are members of the AICPA. We have previously recommended that the Securities and Exchange Commission (SEC) require all firms practicing before it to undergo periodic peer reviews. The federal government is exposed to potentially tremendous losses from its deposit insurance program. Therefore, every step possible, including mandatory peer reviews of accounting firms doing audits of insured institutions, should be taken to protect its interests.

In addition to steps to ensure the quality of management and auditor reports and the independence of the auditors, two other issues should be considered as a means to enhance financial reporting. First, insured banks and savings associations should be required to provide more disclosure in their annual reports on the risks and uncertainties facing them that are relevant to assessing their financial condition.

Currently, the SEC requires management of public companies to include in their annual reports a section often entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A)." The Office of Thrift Supervision (OTS) also requires a savings association applying to convert from mutual to stock form to include an MD&A section in its request. In the MD&A section, the SEC and OTS require management to discuss known material events and uncertainties which would be relevant to an assessment of the entity's financial condition, results of operations, and future prospects.

Requiring all insured banks and savings associations to provide more information on risks and uncertainties in annual reports would help regulators, the deposit insurer, depositors, and other financial statement users make better judgments on the areas of operations that deserve additional supervisory focus and on the continued viability of the institution.

Second, auditing and on-site examination requirements should be augmented for money center banks and other large banks and savings associations that, if they fail, would cause a significant loss to the insurance funds. Options that could be considered include:

-- allowing the regulator to appoint an auditor to conduct a joint audit of the institution with the auditor appointed by the institution,

-- requiring that the quarterly financial information submitted to the regulators by such institutions be reviewed by auditors using procedures established by the regulators in consultation with the accounting profession, and

-- requiring more frequent, on-site regulatory examinations of larger institutions.

CONCLUSION

American taxpayers are having to pay billions of dollars to resolve the savings and loan crisis. I believe that we owe it to them to take whatever steps are necessary to prevent another crisis of this magnitude. Positive action to identify and correct internal control weaknesses, noncompliance with laws and regulations, and fraudulent financial reporting is crucial. Enacting requirements similar to England's requirements for auditor and management reports and communications between the regulator and the auditor would be an important step in the right direction. As we have stated, consideration should also be given to establishing other requirements to enhance the quality of management, auditor, and financial reporting.

Sincerely yours,

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Enclosures - 2

GAO Comments on Establishing a Closer Relationship Between Regulators and Financial Institution Auditors

This responds to the Department of the Treasury request for comments on whether a closer relationship between depository institution auditors and regulators would benefit the deposit insurance system. As requested, we have addressed the following issues: (1) should the independent auditors and accountants of a federally insured depository institution be required to report the results of any audit of the institution to the appropriate regulator(s); (2) should the appropriate regulator(s) be required to share reports on a depository institution with the institution's independent auditors and accountants; and (3) should the independent auditors and accountants of a federally insured depository institution be required to participate in conferences between the regulator and the depository institution.

In summary, we would support authorizations and requirements for federally insured banks and savings associations similar to those reflected by the three issues raised, and which are contained in many of the provisions of England's Banking Act.

England's Banking Act of 1987 contains requirements applicable to English banks and their auditors and accountants which address some of the three issues presented above. As a preliminary observation, we note that England's Banking Act of 1987 builds on the provisions of the Companies Act of 1985 requiring financial audits and reports by banks and other public companies.[1] Unlike in England, banks in the United States are under no general statutory or regulatory requirement to have annual independent audits. However, some banks are subject to audit as part of the Federal Reserve bank holding company regulations, Securities and Exchange Commission requirements, or state chartering laws. In addition, under a Federal Deposit Insurance Corporation (FDIC) policy statement, applicants for deposit insurance coverage will be required to obtain an independent annual audit for at least the first 3 years after FDIC grants deposit coverage. Federally insured savings associations are required to be audited annually by regulation, rather than by statute.

Some of the auditing and reporting requirements of England's Banking Act address issues related to improving financial management and disclosure that GAO has been concerned about over the years. For example, we supported efforts to include language in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) that would have required institutions to issue reports on the effectiveness of their internal controls and compliance with laws and regulations, and to undergo an annual financial audit. As part of this audit, we proposed that the auditor issue a report to the Federal Deposit Insurance Corporation on management's assertions contained in its report. Also, in recent studies, we have recommended annual independent audit and reporting requirements and direct notification to regulators by terminated auditors. We also supported a general requirement that, under certain circumstances, auditors report information outside of the audited companies.

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[1] The Companies Act of 1985 is largely a consolidation of prior acts that predate 1985. In addition, audit and reporting requirements for "building societies," the equivalent to our savings associations, are contained in England's Building Societies Act of 1986.

Issue I - Should Independent Auditors and Accountants of a Federally Insured Depository Institution be Required to Report the Results of Any Audit of the Institution to the Appropriate Regulators

United Kingdom legislation requires management to submit to the regulator audit reports on a bank's internal control system. Section 235 of England's Companies Act of 1985 requires bank directors to report on the development of the bank's business. Schedule 3 of England's Banking Act of 1987 requires banks to maintain accounting records and internal controls. The Bank of England, the principal regulator of banks in the United Kingdom, in interpreting these provisions, requires the auditors to report to the directors or senior management on the bank's internal control system. In addition, sections 236 and 237 of the Companies Act require annual audits and reports on banks' accounting records and financial statements, including assertions made in the directors' report concerning such accounts.

We support requirements applicable to all federally insured banks and savings associations for annual audits and reports. Such a requirement is already in place for savings associations. Office of Thrift Supervision (OTS) regulations require that an independent auditor's report on the institution's financial statements and an audit report on any material weaknesses in internal controls be filed annually by the institution with the regulator. Also, as noted above, we had supported as part of FIRREA a proposal for auditing and reporting requirements for all federally insured banks and savings associations. The proposal we supported would have required institutions' management to report on their internal control structures, including controls to ensure compliance with laws and regulations related to safety and soundness. It also would have required annual audit reports on institutions' financial statements by independent auditors, including reports on the assertions in the management reports.

In our recent studies of the factors causing banks and savings association failures, we found that serious internal control weaknesses contributed significantly to the failures of those institutions.[2] In our reports, we recognized that management is responsible for maintaining adequate internal control systems, and that management reports and auditor reviews are needed to provide reasonable assurance that the controls are being maintained. To address the serious internal control weaknesses, we recommended that Congress, as a condition for federal deposit insurance, require each insured bank and thrift to (1) prepare annual management reports describing management's responsibilities for preparing financial statements and for establishing and maintaining an effective internal control structure, including controls to ensure compliance with laws and regulations, and (2) obtain an annual independent audit of its financial statements. The auditor would be required to issue an opinion on the institution's financial statements and a report on management's assertions regarding the effectiveness of the institution's internal control structure and compliance with laws and regulations.

Issue II - Should the Appropriate Regulators be Required to Share Reports on a Depository Institution with the Institution's Independent Auditors and Accountants

Section 83 of England's Banking Act of 1987 authorizes the Bank of England to disclose information to a bank's auditor or reporting accountant if it would assist the Bank of England in the discharge of its functions under the act or otherwise would be in the interest of depositors.

We support the concept of requiring regulators, except in limited circumstances, to share reports with an insured institution's auditors and accountants. Such report sharing would help ensure that high quality audits, which are in the regulators' best interests, are performed on insured institutions. Requiring federal regulators to bring matters to the attention of a depository institution's auditor is especially important when the regulator believes a matter is so important that the auditor's knowledge of it could significantly affect the form of the audit or the way in which the auditor's responsibilities are carried out. We note that OTS currently has regulations which authorize it to provide a savings association's independent auditor with access to the institution's examination reports if the auditor agrees in writing not to disclose the examination report or any portion thereof. In addition, section 931(a) of FIRREA requires federally insured financial institutions to provide their auditor with copies of the institutions' most recent reports of condition and examination, and certain information on supervisory actions concerning the institutions.

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[2] Bank Failures: Independent Audits Needed to Strengthen Internal Control and Bank Management (GAO/AFMD-89-25, May 1989); Thrift Failures: Costly Failures Resulted From Regulatory Violations and Unsafe Practices (GAO/AFMD-89-62, June 1989).

However, we do not believe the requirements of section 931(a) of FIRREA are sufficient because that provision relies on the institution to provide the auditor with reports and information. We believe the regulator should be required to notify the auditor of the existence of pertinent regulatory reports, and respond to the auditor's request for such reports. However, there should be exceptions to any general requirement for report sharing by regulators to cover sensitive situations such as those involving litigation and ongoing actions or investigations. In such cases, the regulator should notify the auditor that the reports are not available and explain why they are not available.

Issue III - Should Independent Auditors and Accountants of Federally Insured Depository Institutions be Required to Participate in Conferences Between the Regulator and the Depository Institution

While England's Banking Act does not expressly authorize or require auditors to participate in meetings between the Bank of England and banks, section 47 of the act authorizes auditors to communicate information to the Bank in good faith on a matter which they become aware of in their capacity as auditors, and which is relevant to any function of the Bank under the act without being regarded as having contravened any duty to which they may be subject whether or not the communication was in response to the Bank's request. Audit Guideline 307, which was issued by the Bank, indicates that section 47 of the act permits auditors to communicate with the Bank at meetings. (See Enclosure II for our comments on the section 47 authorization for auditors to communicate in good faith to the Bank.)

We generally support the concept of auditor participation in meetings between regulators and insured depository institutions. Such meetings are an appropriate means of exchanging information between the regulator, the institution, and auditor. Specifically, they would provide an opportunity for the auditor to discuss the affairs of the institution, including the opportunity for the auditor to explain any accounting issues which may be of concern to the regulator, and to hear the regulator's concerns directly. However, auditor participation in meetings or conferences should only occur when it is requested by the institution or the regulator.

While we support auditor participation at conferences with regulators and depository institutions, we are concerned that any such participation be balanced with appropriate protection for the auditor. In this regard, we note that section 47 of England's Banking Act insulates the United Kingdom auditor from any liability for disclosure of information which might otherwise contravene any duties to the client. There is no such protection for U.S. auditors. (See discussion in Enclosure II, Item F.) Any provision for auditor participation in meetings should also provide a corresponding limit on auditor liability for any potential disclosures by the auditor at such meetings which could place the auditor in breach of any duties owed to its client.

GAO Comments on Significant Provisions of England's Banking Act of 1987

In addition to requesting comments on the three issues addressed in Enclosure I, the Department of the Treasury also requested comments on the feasibility of adopting regulations that are the same as, or similar to, the audit provisions of England's Banking Act of 1987, which affect the Bank of England's relationship with auditors and reporting accountants. You specifically mention sections 8, 39, 41, 45, 46, 47, 82, 83, 85, and 94 of that act. This enclosure responds to your request to the extent that comments on those provisions have not been provided in Enclosure I.

We have examined the cited provisions of the Banking Act of 1987 and would support federal regulations containing requirements and authorities similar to those contained in the following provisions.

-- Section 8(5), requiring auditor reports in connection with an application to do business;

-- Section 39(1)(b) and (2), authorizing the regulator to require a bank to provide supplemental audit reports and to prescribe the form and content of audit reports;

-- Section 41, authorizing the regulator to appoint investigators and imposing a duty on auditors to provide such investigators with requested information;

-- Section 45, requiring audited accounts and audit reports to be open to public inspection;

-- Section 46, requiring direct notice regarding a change of auditor; and

-- Section 47, authorizing an auditor to communicate to the Bank of England certain information or opinions notwithstanding any duty to the auditor's client.

Except in certain circumstances, we do not support federal regulations similar to the requirement in section 39(2) that reporting accountants be nominated or approved by the regulator. In addition, other than to note that there are similar authorities and requirements in U.S. law, we have no comments on section 82, placing general restrictions on disclosure of confidential information by any person receiving such information; sections 83 and 85, providing exceptions to restrictions on disclosure of confidential information; and section 94, imposing criminal penalties for providing false or misleading information to regulators.

A. Reports Required in Connection with Application to Do Business

Section 8(5) of England's Banking Act of 1987 authorizes the Bank of England to require an auditor's report on information provided to the Bank in connection with an application to do business.

We support federal regulations which would have a similar effect with regard to institutions applying for federal deposit insurance. We believe that it is necessary for institutions applying for federal deposit insurance to be subject to the same auditing and reporting requirements as institutions already insured. Imposing such requirements on applicants would help ensure that their operations and financial affairs are being conducted in such a way that the interests of depositors will be protected and that they ultimately would not pose a risk to the insurance funds. Proposals which we previously supported (see Enclosure I) required annual financial audits of institutions applying for federal deposit insurance.

B. Power to Obtain Supplemental Reports; Appointment of Reporting Accountant; Form and Content of Reports

Section 39(1)(b) of England's Banking Act requires a bank to provide the Bank of England with a report by an accountant on information which the Bank has required or could require for the performance of its functions under the act. We support regulations similar to this requirement. If federal regulators need supplemental information from an insured financial institution, they should have the flexibility to require that such information be reported on by an auditor or accountant.

Section 39(2) of the Banking Act requires that an accountant reporting under section 39(1)(b) of the act be a person nominated by the Bank of England. We recognize that U.S. regulators already have the authority to employ auditors and accountants to assist them in the examination and inspection of insured institutions. In general, we would not support a requirement which would result in the regulator approving an institution's auditor of record. Nomination and approval of reporting accountants by a federal regulator is generally unnecessary as long as an accountant meets professional standards established by the accounting profession and state regulatory authorities. Further, requiring institutions to establish an audit committee, which would appoint and review the work of the auditor, is a more appropriate means to ensure auditor independence.

Nonetheless, auditing and on-site examination requirements should be augmented for banks and savings associations that, if they fail, would cause a significant loss to the insurance funds. One option to augment current requirements would be to allow regulators to appoint auditors to conduct joint audits of such institutions with auditors appointed by the institutions.

Section 39(2) of the Banking Act also authorizes the Bank of England to prescribe through notices (regulations) the form and content of audit reports. We support regulations similar to this requirement. The proposal which we previously supported was similar in that it would have authorized the Federal Deposit Insurance Corporation (FDIC), in consultation with the Comptroller General, to determine the form and content of audit and management reports. This aspect of our proposal was linked to specific criteria for management reports and auditing standards. The proposal required that FDIC, in consultation with the Comptroller General, prescribe specific criteria for management reports. It also required the use of generally accepted auditing standards (GAAS) for financial statement audits, and that FDIC prescribe attestation standards for application to management assertions made in management reports.

Criteria for management reports and auditing standards for financial statement audits are essential ingredients to accurate financial reporting. Thus, we support regulations imposing such requirements.

C. Investigations

Sections 41(1) and (5) of the Banking Act authorize the Bank of England to appoint persons to investigate banks and impose a duty on auditors providing reports under sections 8(5) and 39(1)(b) of the act to disclose such information as requested to the investigators.

We recognize the benefit of such a requirement. The duty imposed on auditors would require them to produce all documents relating to the financial institution which are in their custody or control, including the auditor's own working papers.

However, we have serious concerns regarding the impact of such a requirement on the auditor/client relationship. As we noted in Enclosure I, section 47 of the Banking Act provides the English auditor who discloses certain client information with protection from liability for such disclosures. It should be made clear that any auditor reporting or disclosing information under a duty similar to that imposed by section 41(5) of the Banking Act and with similar protection from liability would be beneficial to any investigative process because such protection would ennance auditor cooperation without fear of breaching any duty to the auditor's client.

D. Audited Accounts and Reports Open to Public Inspection

Section 45 of England's Banking Act requires a bank to make available for public inspection its most recent audited accounts at United Kingdom offices where it holds itself out as accepting deposits.

We support such a requirement. The proposal which we previously supported required copies of audit reports filed with regulators to be made available for public inspection by regulators, unless restricted by law or regulation.

E. Notice Regarding Change of Auditors

Section 46 of England's Banking Act requires that the Bank of England must be notified by (1) a bank, if an auditor is removed or replaced, and (2) the auditor, if the auditor resigns, does not seek reappointment, or decides to make qualifications to the bank's accounts.

There are no statutory notification requirements in U.S. law. However, some insured financial institutions are subject to notification requirements as part of the regulatory process under Securities and Exchange Commission (SEC) and Office of Thrift Supervision (OTS) regulations. Both SEC and OTS require indirect notification from the audited institution, rather than direct notification from the auditor. Under SEC regulations, the institution must report the change of auditor to the SEC, and provide a letter to the SEC from the former auditor stating whether the auditor is in agreement with the reasons for the change. OTS regulations provide a similar procedure for savings and loan associations, except for an additional requirement that the auditor must discuss the reasons for the termination or change with the regulator, after notification of the change by the thrift. Under a recent American Institute of Certified Public Accountants (AICPA) rule, accounting firms which are members of the SEC practice section must notify the SEC directly if the auditor resigns, does not seek reappointment, or is dismissed.

The AICPA's direct notification rule does not apply to all auditors who may be engaged to audit an insured institution. Therefore, we support a direct notification requirement similar to that in section 46 of England's Banking Act.

F. Communication by Auditor with Regulator

As we noted in Enclosure I, section 47 of England's Banking Act authorizes auditors to communicate information to the Bank of England in good faith on a matter which they become aware of in their capacity as auditors, and which is relevant to any function of the Bank under the act without being regarded as having contravened any duty to which they may be subject whether or not the communication was in response to the Bank's request.

There is no similar provision in U.S. law. We support a similar provision with limits on auditor liability because it could help protect the interests of depositors of the institution when there is an adverse occurrence or change of circumstances involving the institution. In our recent study of the implementation of changes to improve auditing and financial reporting of public companies, we supported a general requirement that, under certain circumstances, accountants report information, particularly on fraud, outside the audited company.[1] We noted that the extent to which such reporting should be required has not been resolved, and that there is no consensus on this issue among the public accounting profession and others who are concerned with audit quality and the accuracy and reliability of financial disclosures. Nevertheless, we concluded that such reporting is necessary and appropriate in certain circumstances.

While we support the concept, we note that the institution should continue to be the regulator's primary source of information, an arrangement which preserves the auditor/client relationship, and insulates the auditor from liability for breach of any duties owed to the institution. The responsibility to provide the regulator with information should be placed on the auditor only when the institution fails to report the information or the auditor no longer has confidence in the institution's directors or senior management. In such situations, the auditor should first attempt to report the information through the institution's audit committee. If the audit committee is unavailable or does not act promptly, then the auditor should be authorized to report directly to the regulator without being subject to liability for breach of any duty owed the institution.

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[1] CPA Audit Quality: Status of Actions Taken to Improve Auditing and Financial Reporting of Public Companies (GAO/AFMD-89-38, March 1989).

G. Restricted Information; Disclosure of Information

Section 82 of England's Banking Act places general restrictions on disclosure by any person of confidential information obtained under or for purposes of, the act. Section 83 of the act provides exceptions for regulatory disclosure by permitting the Bank of England to disclose confidential information (1) for the purpose of assisting it to discharge its functions under the act, (2) if seeking advice from a qualified person, or (3) if disclosure to an auditor would assist the Bank to discharge its functions under the act or is otherwise in the interests of depositors. Section 85 of the act provides additional exceptions to the general restrictions on disclosure imposed by section 82.

We have no comments other than to note that various federal laws currently place general restrictions on the disclosure of confidential information contained in audit and examination reports of insured financial institutions, and also provide exceptions to the general restrictions placed on the disclosure and use of such information.

H. Civil and Criminal Penalties for Providing False or Misleading Information

Section 94 of England's Banking Act makes it a criminal offense to knowingly or recklessly provide the Bank of England, or an investigator appointed by the Bank under section 41 of the act, with materially false information in purported compliance with the act or in connection with an application to do business. Section 94 also makes it a criminal offense to fail to disclose relevant information to the Bank when it is known that withholding the information was materially significant to the exercise of the Bank's functions.

We have no comments other than to note that Title IX of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 provides civil and criminal penalties that go far beyond the scheme provided in section 94 of the Banking Act. Specifically, subtitle A of Title IX increased the civil money penalties banking agencies may impose for violation of the banking laws, expands the conduct warranting the imposition of such penalties, and significantly strengthens the banking agencies' enforcement powers. Subtitle E imposed civil penalties on financial institutions or officials who act knowingly or with reckless disregard in violating laws, regulations, or orders. Subtitle F increased criminal penalties for certain financial institution offenses and provides for civil and criminal forfeiture procedures for any property obtained in actions or transactions constituting financial institution offenses. In addition, it is a felony under the federal criminal code to knowingly and willfully provide false statements to the federal government.

The **Chairman**. I kept waiting for the good news.

Mr. **Bowsher**. Well. I wish I could give you the good news. I really do, Mr. Chairman.

The **Chairman**. What you've said today presents a very serious picture and situation. You've been very careful about choosing your phrases in your description of the problem.

But it sounds to me as if in a number of banks the accounting might not accurately reflect the true economic situation there is, continued erosion of real estate values in both commercial and residential properties. It's conceivable, from what I hear you saying, that we may have unrealized losses out there right now that may exceed what's left in the insurance fund.

Is that fair?

Mr. **Bowsher**. That's a fair statement, Mr. Chairman. In other words, we're concerned that, with the known losses that people are working on right now over at the FDIC, and the potential for the failure of some large institutions—the fund is under severe stress.

See, when you get the fund down to 0.7 percent of the industry's insured deposits, you have a lot of individual banks in this country that if they were to go under, could take the whole fund.

So we're at a point where the fund balance is very small compared to the deposits it insures. We believe that one of the things that has to be done is to build this fund up to a much more substantial balance.

Another problem, too, you have to recognize that in the 1980's, the financial institutions took on more exotic lending. So that the risks are higher.

In other words, when we're looking at the fund and historic balances of what the fund was prior to 1980, when it was more than adequate and always had a profit. We were dealing with a banking system that was much more stable, had many fewer types of instruments that they were loaning money on and things like that.

And when you see activities like these highly leveraged transactions being financed by banks, you realize that the risk of loss has become much greater and that traditional fund ratios may no longer be sufficient. That's one of the reasons why we are urging in our report that the Treasury Department come to the Congress with a new study as to what they think the level of the fund should be compared to the deposits that are being insured against, and not just accept this 1.25 percent.

I think it would be our feeling, the people that worked on these audits the last 2 or 3 years, that the fund needs to be considerably higher than that. We don't know exactly how much higher, but that's the kind of study that needs to be done by Treasury. We would be happy to review it, of course, at that time.

The **Chairman**. Well, it seems to me that, in light of all of the negative factors at play here that you really can't certify to us that there is, now, a true, positive balance in the fund. There's a reported balance, a positive balance in the fund. But there may be outstanding claims against that balance——

Mr. **Bowsher**. We can report that there is a fund balance as of the end of last year, according to generally accepted accounting principles.

But what we're raising here is whether, if we had a more realistic standard that everybody was measuring things by, there would be a fund balance of $13.2 billion. As we already stated, we identified costs totaling several billions of dollars that, under more realistic accounting standards, should have been booked last year.

The Chairman. What concerns me is we saw that pattern in the savings and loan industry. There are important differences, and I want to stress them. But the losses that were embedded there did not show up early. There was a delay because of accounting treatment and the way we handle these issues.

Mr. Bowsher. In that case, you had the additional problem of regulatory accounting which became more lenient as problems went on. But in this case, what I'm raising is the fact that I'm not sure that generally accepted accounting is adequate for the job.

The Chairman. But the bottom line is, in fact, that you cannot certify that there is a true economic surplus in the system at this moment in the insurance fund.

Mr. Bowsher. That's correct. What I can say is that I think the fund is going to be several billion less and I think that Chairman Seidman has already admitted that in 1990, and what we don't know is how many more banks may require assistance from the fund.

The Chairman. My time is nearly up and I want my colleagues to get into this discussion. But I think something needs to be done about this problem now in addition to the increase in the premiums that the FDIC is already talking about. I have great confidence in Bill Seidman, but this problem is a lot bigger than the reach of a single competent regulator.

It looks to me as if broad, endemic factors are at work in the banking system to cut down on asset values.

I think that, in addition to the recommended increase in insurance premiums, other steps may be needed. I'm not quite sure this minute what those might be, but your information today and what I expect to hear tomorrow from the Congressional Budget Office, necessitates our asking the administration and offering to work with the administration to figure out what other steps are needed.

We cannot afford to allow the insurance fund to be depleted. That is something that cannot be accepted or tolerated and it doesn't have to be.

It may well be that we already have embedded problems in a dimension beyond what anybody fully contemplates right now. You've put your finger on some of them. Some come from agreements already made that will require heavy outlays that aren't yet being entered into this equation.

But we are going to have to have recommendations to head off problems of this kind. It would be very damaging to the psychology of the country to allow this fund to be depleted. We cannot allow that.

Mr. Bowsher. If I could also just add one more observation here. And that is what would also be very bad is if we see the fund depleted and we don't know it's coming because of the reporting that we're getting.

The Chairman. Yes.

Mr. **Bowsher**. I really feel that the reporting has to be improved at all levels but particularly at the individual bank. In other words, I think we need the adequate controls at the individual bank. We need the audit committees and the board of directors to be getting accurate information at those banks as to the banks' condition. The outside auditor should play his role, as should the bank regulators. And we should reduce the reliance on off-site monitoring and get to on-site auditing so that we're really looking at the actual condition of the institutions.

I think we need improvements in the regulatory process. The regulatory process needs to enable the regulators to identify a problem institution early on. I used to say at the Pentagon, the last time we got good information from the prime contractor, by the time it came through all the layers at the Pentagon, the Congress never got notified that there was a cost overrun problem.

Well, that's the same in banking here. You've got to get the regulators' staffs, their examination staffs and their reporting process in order, in good shape, giving us timely information. At that point, the condition of the fund can be properly appraised and Congress can be accurately informed as to what the size of this problem is.

If we don't concentrate on that, I think we'll be making a big mistake here and we'll fall into the trap that we did with the S&L's, and that is that we're trying to make decisions without knowing exactly how bad the problem is.

The **Chairman**. Thank you. Senator Garn.

Senator **Garn**. Mr. Chairman, you suggest a lot of reforms that are necessary, and certainly a lot of questions that need to be answered by the Treasury study.

Congress and the agencies are certainly going to be dealing with many of these issues next year. I am concerned, however, that we have a clear reading from you on whether you think that there are additional steps that we might take now?

In other words, to put it bluntly, is next session soon enough?

Again, I recall 1986, as chairman of this committee, begging and pleading and finally getting Congress to do something about it, or at least the Senate, in October 1986. But we left session without doing anything at all. The only thing that happened by March or April was that the problem was much, much more severe.

As a matter of fact, in October 1986 when we left session, GAO was telling us that the FSLIC fund was losing $6 million a day. By the time we came back the next session, we were losing $10 million a day.

So my question is can we wait, or should Congress stay here and do something about it? Is it soon enough to wait for the Treasury study that we've been waiting for for a year, or should we be staying here and doing something now? Because I don't want to be part of another fiasco like in 1986 of trying to get something done and having the House sit on their hands and do nothing, not even extend the emergency provisions of Garn-St Germain that expired September 30, 1986.

So with your analysis, should we be doing something now? Can we afford to wait, when everybody says, well, we'll get back next year and we will address these reforms?

Mr. Bowsher. I think if you could do it before you go out, it would be much better.

In other words, I'm very pleased that the FDIC has increased the assessment rates to try to start building up the fund.

I would think that putting some pressure on Treasury to come forward with their study to see if they have some kind of guidance for you on what the appropriate fund level should be, and then I think maybe any additional effort to increase the fund balance could be enacted before Congress recesses.

I also think the committee should act to enact legislation addressing the need for improvements in internal controls in financial institutions.

I think that's awfully important. In other words, I think we should not have weak controls in financial institutions and improvements could be made through legislation. In fact, there are currently other congressional committees that are studying this issue. I would think that the Banking Committee ought to give that very serious thought.

I think asking that the on-site full scope——

The **Chairman.** Examinations.

Mr. Bowsher. Examinations by the regulators that should be done annually. That could be done any time.

In other words, I know that—and they should be really targeting those banks on their problem lists for closer supervision.

Now one of the problems is that they've got some banks that show up in great trouble that never get on the problem list. That should never happen. But it has happened here in the last 24 months. Some large ones, too.

So it seems to me that the regulators should be out working very closely with the situations and trying to find out the true conditions of these banks. I think your committee holding hearings, asking them what they're doing on this, could be very helpful.

We've studied how some of the overseas countries supervise their banks. We found that there is a much closer working relationship between the bank regulators, supervision people who are in there doing examinations, and CPA firms, or chartered accountants, as they generally refer to them. In our country, regulators and independent accountants seem like they all want to work separately and they don't share with each other.

It makes no sense.

In other words, I think that we need cooperation between regulators and independent accountants. I think a letter from this committee to the AICPA to start looking at the accounting standards we've identified as weak is very important. As long as bank managers and accountants keep deferring recognizing losses no one in the system will get the proper warning needed to minimize losses to the fund.

Don Chapin has done a lot of work in this area and I'd like Don to explain this just a little more to you so that you understand this very important point.

Mr. Chapin. On the accounting issue, what we see in the failed banks is that the banks seem to fail overnight, and that's really not correct. Banks don't fail overnight. They begin to show signs of trouble early on. And those signs are not being properly measured by the present system of accounting.

What we have here is a system of loss recognition where the loss must be probable before it's recognized. "Probable" has been interpreted to mean virtually certain.

So when you have a bank in trouble and you have a bank president that doesn't want to show the loss, he's in a position of talking to his accountant about the nature of the loss and he claims that this loss is not probable, it's not virtually certain. It allows too much flexibility in terms of loss recognition.

We think that that can be dealt with by the accounting profession.

We also think that when it comes time to score the loss or measure the loss, that reference is made to the appraisal language which permits the loss to be measured in terms of a longer-term perspective, the possibility of improving conditions.

When a bank's in trouble, longer-term perspectives aren't appropriate. You really have to measure the loss——

Senator **Garn**. Don, maybe you'll excuse me for interrupting you, but I would like to ask one more question before my time is up.

Let me just summarize by saying that, obviously, we're not going to pass under any circumstances any overall major reform. The intent of my question, and I would appreciate it if you would in writing, if there are any other specific measures that we could enact now, either regulatorily, encourage them in these accounting areas, increase FDIC's ability to raise premiums while we're gone, if necessary, things like that that are realistic to be done before we leave.

Mr. **Bowsher**. All right.

Senator **Garn**. The second thing——

Mr. **Bowsher**. Why don't I answer that, then, Senator, and that is we'd be pleased to give you a list, a specific list on that.

Senator **Garn**. That's what I would very much appreciate.

Mr. **Bowsher**. Yes. We'd be happy to do that.

Senator **Garn**. Second, I read today in both the Wall Street Journal and the Washington Post, "U.S. May Keep Weak S&L's Open and Closely Watched."

Sometimes around here, its deja vu. I hope you would agree—I've gone through that up to here and above with forbearance. That's what it is.

Mr. **Bowsher**. That's exactly right.

Senator **Garn**. We're once again talking about forbearance. And I heard regulators and Members of Congress talk about forbearance all through the 1980's and I've had a belly full of forbearance.

Would you agree that this kind of talk is a little bit ridiculous at this point in time?

Mr. **Bowsher**. I'll tell you, I was a little bit shocked to read it this morning, and I have to find out more of what they have in mind and everything like that. But I think we have to be very careful. And you state it very well, going back to the forbearance game.

Senator **Garn**. Well, I too shouldn't judge from headlines. I haven't had a chance to dig in more deeply.

Mr. **Bowsher**. But it does bring back bad memories.

Senator GARN. This Senator has got a lot of bad memories about sitting in conferences and listening to people beg to keep my institution open and to "just leave it alone, it will be fine."

Mr. BOWSHER. It will work out, yes.

Senator GARN. Thank you, Mr. Chairman.

The CHAIRMAN. Let me just say, Senator Garn, that this issue arose somewhat unexpectedly, yesterday, when we had Chairman Seidman, Chairman Breeden of the SEC and others here for a hearing. Senator Bond asked a question of Chairman Seidman. It went in an unanticipated direction. To my surprise and Senator Bond's surprise—we were the only two Senators here at that particular moment—we heard something that sounded like forbearance. A sure change in direction.

Senator GARN. Well, the nastiest word in this Senator's vocabulary is forebearance.

The CHAIRMAN. The transcript from yesterday is still being printed but it will be available today. I'm going to make sure that a copy is available to everybody because it includes a very important set of unanticipated statements from the witnesses yesterday.

But I want to add one footnote. The fact that they are now considering this indicates that the problem may, in fact, may be more serious than anybody has yet been willing to say or even fully understand.

The meaning that I drew from their comments was that this situation, especially the erosion of real estate values, is deteriorating so rapidly that it's creating a concern as to whether they're going to have to revise their strategy.

That came as a surprise to us, but we'll see what further they have to say.

Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Mr. Bowsher, I want to address your comments on pages 12 and 13 of your statement.

You've been very clear this morning that you support the FDIC raising the deposit insurance rates to the limit permitted under the existing legislation.

Is that correct?

Mr. BOWSHER. That's correct.

Senator SARBANES. All right. Then you say that you believe that legislation should be amended to allow them to raise the rates even higher.

Mr. BOWSHER. That's correct.

Senator SARBANES. OK. Now, on the previous page, you say that you believe that the Department of the Treasury should assess banks' ability to pay higher premiums and estimate at what point such higher premiums may become counterproductive in their benefit to the fund.

Have you done that yourself? Do you have any sense of what that level may be? And in particular, I take it you must see that level as being significantly above the maximum now permitted if you're prepared to recommend amending existing legislation to provide for higher rates.

Mr. BOWSHER. We have done some work to see just what the impact would be of going up to the limit, which is what the FDIC decided to do. We thought at that time that the banking system could absorb that increase. It amounts to 1 percent and as much as 2 percent for some of the larger institutions as far as their costs. So that's the type of increase you're talking about, compared to their other costs.

We aren't sure how much higher they can go above that. We have not done that study. But we are quite convinced that this .195 is not going to be adequate, considering the banking situation.

So we really think that legislation should be in place when finally not only does the Treasury come forward, but when the Congress agrees as to what additional increase ought to be.

So our study really has kind of been up to that point and we think it is probably going to have to go higher, but we don't know how much higher or we don't know how much of an impact that would have on the banks and we think that that should be all worked out by the Treasury people, and then advise you people.

Senator SARBANES. Is it your conclusion that you could go above the limit to which the FDIC has now taken it without it being counterproductive?

Mr. BOWSHER. We think you could, yes, we do.

Senator SARBANES. So you have any sense of how much above?

Mr. BOWSHER. No, that's what we do not have. And that's why I think a study by Treasury people is very appropriate, is needed, and what you people should be asking for.

Senator SARBANES. Now how important do you think raising the bank capital levels is in addressing this situation?

Mr. BOWSHER. Well, we're doing a lot of work on this whole area of banking, both for your committee and for the House committee on that.

The capital is, of course, one of the key issues. I think we've got to have adequate capital in our banking system here in the future. And I think most of the people, Chairman Greenspan and everybody else, is coming to that conclusion, that this is a problem that we've had, and that our financial institution system is too thinly capitalized, and we've got to get that up.

We at this time do not have firm recommendations, but we're working on that problem, and I would hope——

Senator SARBANES. Did you read the reports on yesterday's hearing?

Mr. BOWSHER. Yes, we did. I would be on the side of not going to where the Comptroller of the Currency was yesterday.

In other words, I would be very much on the side of leaving the capital requirements where they are now until we know what we want to do, and the idea of letting thousands of banks reduce their capital would not be our recommendation.

So we would be siding with the Fed and Mr. Seidman on that issue and not with the Comptroller of the Currency.

Senator SARBANES. And how important do you think that is?

Mr. BOWSHER. Well, I think it's fairly important because I think we're probably going to come out here recommending higher capital and I think for us to take a temporary dip down and allow banks to go lower and then say later, well, we probably want you to go higher, doesn't make a lot of sense to me.

Senator **Sarbanes**. Well, I agree with you on that. Thank you very much, Mr. Chairman.

The **Chairman**. Thank you, Senator Sarbanes.

Senator Graham.

Senator **Graham**. Thank you very much, Mr. Chairman.

I would make a comment before I go to questions, and that is that I believe that in 1988, this committee accepted the representations made by the regulators who were supposedly in the best position to assess the condition of the fund, and based on that recommendation, did nothing.

I am not satisfied that we take that position in 1990. I have been reviewing some of the comments that have been made to this committee earlier this summer, primarily in response to the July 15 statements of Mr. William Seidman, in which he stated that the FDIC fund was under considerable stress. In response to the questions of what should the Congress do now, we've had as an example from Chairman Greenspan the statement,

> I would assume if there are any recommendations, they will evolve in the context of the FIRREA-mandated study which the Treasury is involved with and which we at the Fed are acting in concert with them.

A few days later, a similar question was asked of Secretary Brady, on July 25—what action should the Congress take? And his response was:

> Not at this time, although we are studying the matter. I have asked Bill Seidman to give us any conclusions he might have so that we can look at them.

That passivity, lack of a sense of urgency, I think is in direct contrast to the report that you have given us today.

And I would hope, Mr. Chairman, that this committee would not follow the advice of inaction, but would accept its responsibility to move forward. And I believe that Mr. Bowsher has given us the beginnings of an agenda of what that action might be.

Mr. **Bowsher**. If I could just add one thing there, Senator Graham, because you're absolutely right. I hope that our message here today is that we need action and we've got to address these problems. The problems are bigger than what has been reported in the past.

If we had not done that special study, which was my second bullet here today, looking at the hundred largest banks and the 200 largest problem banks—in other words, we looked at the problem bank list, which is over a thousand, and we said, let's look at every one that's over $100,000,000. So that's how we did this. And let's just see what is the trend, what is the capitalization, like that. And that's where we came up with this finding that we think that many of them are going under.

And we think that 35 are in serious shape, of which quite a few have already gone under in 1990.

Now that's the kind of extra effort that I feel was necessary and it was really only in the last 6 weeks that we could show that to Mr. Seidman and his staff and things like that, although we'd been working with him on it and everything like that.

But that's what I feel has to be done by the regulators. In other words, we were right to do it as auditors, but they should have been also doing it.

And so I think one of the clear signals that has got to be given by this committee is to the regulators to really dig deep now and find out what the extent of the problems are and what are the corrective actions that have to be taken. And we shouldn't be complacent.

In other words, this is a fund that has come down significantly as far as what it's trying to cover and we've got a lot of situations out there that could wipe the fund out. Therefore, we don't have the luxury of assuming that things are going to work itself out.

Senator GRAHAM. Let me use that comment as the basis of my first question.

There is a disturbing similarity in what's happening now and what happened in the recent past relative to the thrift regulators. And I would say that that would include forbearance, an unwillingness to publicly state the true extent of the problem, and then what will prove to be costly long-term transactions in order to meet short-term financial circumstances with the Southwest Plan being the prime example within the thrifts.

It seems to me that we're falling into some of the same patterns as it relates now to the commercial banks.

What is it systemically in the financial institution regulators that causes this repetitive pattern of avoidance or unwillingness to speak the extent of the truth, forbearance, sacrificing, long-term for short-term actions?

Mr. BOWSHER. I think there's always a hope by a lot of people that the problem will go away, the problem will not be as big as what it might be.

And lots of times, if you look at the facts that are sitting right in front of you now, the problem isn't that big. So you really have to be willing to dig and probe and really go checking the things out to try to do that. And I think that many of our regulators have been understaffed and therefore, they have felt that they've been doing a good job, and they did a good job, an adequate job, for many, many years when we had a much simpler banking and financial institution system.

What they didn't recognize, I believe, is how much changed here in the last 10 years, how much more risk was being built into the system. And therefore, what we really needed was not only probably larger staffs to be checking things out, but an even more talented staff. And, of course, Government salaries do not lend themselves to being able to attract top people.

I got Don Chapin here last year, a retired senior partner from Arthur Young, to come into Government when Fred Wolf left because he can afford it, having his pension in the private sector and a few bucks in the bank, and we're very fortunate at GAO.

And I told Don, one of the first things when he arrived, I said, we've got to get into this banking area more deeply than we have in the past. And now I've got the talent here.

In other words—and Greg and everbody, Bob—they've worked very hard on this effort. But that's what it has to take. And if you don't have that talent, if you don't have that desire to find out how bad is this problem that's building up? Everybody knows it's building. You can read the newspapers and know that it's building on you. Then you're not going to find out the problem.

Senator GRAHAM. Mr. Chairman, my time is up. I'd just conclude by saying, one thing that Congress frequently is criticized for is attempting to micromanage activities. And that criticism is from time to time justified.

To me, we have a macroissue here and that is the demonstrated incapacity of regulators to adequately assess and warn and therefore initiate action before disaster.

And I would hope that your comments today would be part of an ongoing dialog that would lead us to some rethinking of our regulatory structure so that we have some hope of avoiding a repetition of what we're experiencing today.

The CHAIRMAN. I might just say for the record that we've had struggles over the years in exempting the bank regulators from Gramm-Rudman cuts, taking off their salary cap so that we could hire top professionals to match the top professionals in the private sector. And we've made some progress in that area.

We fought off the Gramm-Rudman cuts in that area. We took the salary caps off so that we were able to hire some more highly skilled and trained regulators. But it all came late.

I wrote a bill in 1987 to set up a training program and a school to train regulators, bank and thrift regulators, to get them up to the level of sophistication that this new world of global, deregulated finance requires.

We couldn't get much support for it at the time, but it was needed then and it is needed, I think, even more now.

Just one other thing before I yield to Senator Heinz. It is in direct response to your question, Senator Graham.

I think you're exactly right. If action's needed, I want to take it now. I was not the chairman in 1988. I'm the chairman now. This committee is going to take whatever actions it thinks it ought to take. We may invite a recommendation and response by the executive branch leadership. Whether or not that is forthcoming, we're going to have to make our own judgment about what is required.

I do not intend to wait beyond a reasonable period before we take those steps that are within the scope of our authority.

Senator Heinz?

Senator HEINZ. Mr. Chairman, thank you.

Mr. Bowsher, in your opening statement you concluded that over the next few years, the fund's low level of reserves, accompanied by a recession, could lead to a level of bank failures that would exhaust the fund and require taxpayer assistance.

Has the GAO performed any stress test or economic simulation to determine the extent to which the insurance fund can withstand a recession?

Mr. BOWSHER. No, I wouldn't say that we have done what you ask there.

What we did do, and you'll see it in my testimony and the report, is we did try to see what it would take to get the fund up to 1.25, which is the stated goal in FIRREA, and we just didn't get it there, you might say, in all of the scenarios we use, and there were some favorable assumptions. So that's one of the things that we did try to do. But we did not stress-test, and I'm not sure—that would probably be something that you might ask the regulators to do and for us to review, might be a better way of doing that.

Senator HEINZ. So you can't say whether a mild recession or a serious recession——

Mr. BOWSHER. No, but I think what we can tell you, though, as we looked at these problem banks, and as I mentioned earlier, we looked at 200 of the thousand, a little over a thousand problem banks on the problem bank list. Those we judged were determined by whether they were over $100 million or more in assets. That's where we came up with these 35 banks that were in trouble, and we say that that's a $4 to $6 billion problem that the fund might well be facing here this year.

When we looked at those, the thing that comes across very clearly is, if you've got a few large ones there, if they go into trouble, why, you could wipe out the fund.

In other words, you have a fund today, and an individual bank, and it doesn't have to be the biggest bank, it would wipe out. That's the level that you're down to.

Senator HEINZ. In your testimony, on page 16, you note that since bank failures don't occur overnight, that it's reasonable to expect that regulators should be able to detect an emerging problem before a bank becomes insolvent.

Mr. BOWSHER. Yes.

Senator HEINZ. Proposals for early intervention are, of course, based on the premise that regulators can close failing institutions before they become insolvent.

Yet, you indicate that the GAO uncovered instances where 22 banks failed without an apparent recognition by the regulators that they were in trouble. Nine other banks failed shortly after problems were discovered.

Are you saying that bank regulators are asleep at the switch?

Mr. BOWSHER. No. What we're saying there is that the information that the individual bank is pulling together, even for its own board of directors lots of times, is not accurate enough. We go on to make that statement, I think, a couple of pages later.

So that's got to be cleared up. In other words, you've got to get better accounting at the individual bank coming out to the board of directors and then for the regulators to come in and take a look at, you might say.

Then, yes, we are saying the regulators are not doing an adequate enough job in doing their examinations so that you can have some of these.

So it's really a combination of the two areas that really need to be improved here. And this should be happening.

In other words, occasionally, it might happen, but this tells you that you're not going to intervene early because you don't even know it's happening.

Senator HEINZ. What I think I heard you say is that the regulators aren't requiring the kind of information they need——

Mr. BOWSHER. That's right.

Senator HEINZ [continuing]. To make regulatory decisions. I would have to interpret that as an affirmative answer to my question because while they may not be able to act based on existing information, the regulators do have the authority to compel almost any kind of reporting that they need from financial institutions.

Is that not correct?

Mr. **Bowsher**. That is correct.

Senator **Heinz**. You state on page 17 that because of your concerns, the GAO plans to review the entire examination, supervision programs of bank regulators this fall. That sounds like a very good idea. But what are your specific concerns beyond the one just mentioned, and what is your current assessment of the adequacy of bank supervision?

Mr. **Bowsher**. What we think is that all of the banks that are on the problem list should be getting a full on-site audit. We think that the larger ones ought to be reporting quarterly and you could use the CPA firms maybe to help.

In other words, to receive unaudited data doesn't make a lot of sense when you've got a large bank that's on a problem list, it seems to me.

So it seems to me the regulators have got to build up whatever information processes they need, and to have those processes checked so that the information they're getting is accurate information, and then, it seems to me, they can start to take some action.

Now that leads to page 18, which you're probably leading to, too, Senator, and that is the accounting standards there.

What is probable——

Senator **Heinz**. I'm going to get to that. You're quite right. I'm going to get to that in a moment. You've got great marks not only for being on top of this, but being a mind-reader as well.

But before we get to that, there's one specific question that I want to ask you directly related to a comment which Senator Riegle made which I agree with.

If there's anything that this committee needs to do, we want to do it now, not next year and not later.

Mr. **Bowsher**. Yes.

Senator **Heinz**. Is there any regulatory authority that bank supervisors need—whether or not they've used it is another question—but is there any authority that they need to prevent unsafe and unsound practices and losses to the insurance fund, that is not already available?

Mr. **Bowsher**. We promised Senator Garn here just a few minutes ago that we're going to come up with a list of anything like this for the committee here in the very near future based on our work, whether it's done or not, and give you our very best advice as to what legislative actions need to be taken and what regulatory actions need to be taken. And if there's any gaps in there, why, we would certainly identify those for you.

Senator **Heinz**. At this point in time, do you know of any additional authority that we should confer upon the regulators? Is there anything that starts at the top of your list, or is on your list, even though you may flush it out later?

Mr. **Bowsher**. I think one would be raising the limitation on the premium that is paid in. In other words, Bill Seidman and the FDIC is planning to raise it to the limit. And so we think that you ought to get legislation in there to get it go higher. If the Treasury study and yourselves decide that that should go higher——

Senator **Heinz**. I understand. My question was a little different. That deals with the problem of the fund.

Mr. **Bowsher**. Yes.

Senator **Heinz**. My question was related to unsound practices and losses incurred by the fund, as opposed to the problems of the fund.

Mr. **Bowsher**. Well, I think it goes back also to the ability to take action on the banks prior to what we would call a GAAP insolvency. And I think that ought to be looked at. And we're looking at that, so we might give you some recommendations in that area.

In other words, to allow the regulator to act a little faster than what they can today. And I think also, you know, we have the old issue which I feel very strongly about, and that's the issue of internal controls. I really think that that legislation should be reconsidered this year, and we have draft legislation that we can supply the committee.

Senator **Heinz**. That was an issue that you and I worked very closely on.

Mr. **Bowsher**. Yes.

Senator **Heinz**. Mr. Chairman, I might just ask one question on generally accepted accounting principles, although my time has expired, if my colleagues would oblige me, because Mr. Bowsher brought it up and it is really a part of this.

You expressed the view that generally accepted accounting principles for banks are too lenient, in that they permit an understatement of potential losses and an overstatement of the value of collateral. As a result, you urge that so-called GAAP accounting be changed.

The question I've got is should regulators wait for changes in GAAP—GAAP is being reviewed by the accounting profession—or should they instead require banks to adopt the more stringent accounting requirements that you recommend?

Mr. **Bowsher**. I would like to see the accounting profession address it because my concern about the regulators doing it is getting back to what's known as "RAP" accounting. And all too often, RAP accounting, when it has been used, has actually been used to weaken the accounting standards rather than to strengthen them.

So what I would like to see, and I suggested it earlier, is maybe a letter going from the chairman of the committee here to the AICPA president, urging them to take a look-see at these areas because I think they today do recognize that they have a problem here.

We've already alerted the FASB, and I think if the regulators worked with the accounting standards body, this is something that they could address themselves in the next few months. And the important thing is to address it so that the 1990 audits are coming under some new guidance because, to a certain extent, this is not necessarily the standard has to be changed as much as it is the guidance given to interpret that standard.

Right now, it's being interpreted, as Don Chapin pointed out, early in a very strict manner. And what we're saying here is that the economics of what we're looking at obviously needs something different.

And so I think that by this committee drawing this issue to every body's attention properly, and we'd be happy to work with you on some letters, why, I think that you might well get the right people coming up here with some change in interpretation and guidance that would be very helpful in the calendar 1990 audits, and then next spring, we'd have a much better idea as to where things stood.

Senator HEINZ. Mr. Chairman, I just want to make an observation. I agree wholeheartedly with the observations of the Comptroller General. He is certainly correct that regulatory accounting principles, RAP, were a source of evil in the savings and loan industry.

Mr. BOWSHER. They really were.

Senator HEINZ. Although that is what they were, that is not necessarily what they have to be.

Mr. BOWSHER. That's correct.

Senator HEINZ. If the accounting profession isn't for some reason able to make the kinds of affirmative changes in GAAP that you've suggested, Congress or the regulators have the option of designing—and it's probably a second-best option—a regulatory type of accounting system, in addition to what the accounting profession imposes. While we wouldn't have to do that, nonetheless, that is something we might be required to compel if there are not changes made by the accounting profession that are sensitive to the concerns that we all feel are necessary for a safe and sound banking system.

So, Mr. Chairman, I thank you and my colleagues for this opportunity to just finish that last question.

The CHAIRMAN. I might just say, Senator Heinz, and I want to draw my colleagues' attention to this as well.

There was a long discussion yesterday in the record—committee transcript will be here later today—with Chairman Breeden. Chairman Breeden had a major role in the Government that time and was very much studying and trying to fathom what was going on in the dynamics of the collapse of the savings and loan system.

He used a phraseology yesterday of describing the various techniques of forbearance and regulatory accounting and allowing goodwill to be treated as an asset for capital measurement purposes, and so forth, as an attempt, what turned out to be a failed attempt to try to work out of the savings and loan problem by, in effect, doubling the bet. It was double or nothing. And by a whole variety of techniques, used one after the other during the 1980's that there was an effort to try to take, and a problem that was seen of one size and to resolve it through all of these different techniques and ways of allowing time to solve the problem, when, in fact, as we now see in hindsight, these steps did not have that effect, and in fact, the problem grew bigger, as we now see.

But I thought that his description yesterday, and I would recommend it to you, was a very interesting assessment of someone who had a vantage point that I think is useful for us to consider.

Senator Shelby.

Senator SHELBY. Thank you. I want to tell you, as others have told you, we appreciate your sober and your candid comments. Sometimes witnesses are not as forthcoming.

But it seems to me, from what you've said here today and what you've heard elsewhere, if the sky is not falling, it is shaky. And if it's that shaky and we have over a thousand banks that are in trouble, according to your testimony——

Mr. **Bowsher**. That's the problem list, yes.

Senator **Shelby**. The problem list of over a thousand banks out of how many banks? Eight thousand banks?

Mr. **Bowsher**. Yes. What is it, Greg?

Mr. **Holloway**. It's actually 13,200 that are insured.

Senator **Shelby**. 13,000 banks or more, and over a thousand of them are troubled banks.

You also predicted here, based on your analysis, that 35 of these troubled banks will probably fail and take a big hit, $4 to $6 billion out of the fund within the next year.

But, as has been pointed out here, especially last year by the chairman, we haven't tested a lot of this in the marketplace in a recession, in a down market.

Mr. **Bowsher**. That's correct.

Senator **Shelby**. We have troubled areas in the Southwest. We've had areas in the Northeast to experience some big hits on some banks because of the economy.

But if we get into an overall recession, we've got problems, haven't we?

Mr. **Bowsher**. That's correct, Senator. I think it's amazing how much our financial institutions got into trouble really in a decade of great prosperity.

Senator **Shelby**. So how do we get out of this? Do we do it by forbearance? All of us say, goodness, no, you know, like the chairman was just quoting Dick Breeden. It's double or nothing. We don't need any more casinos around here. We don't need a casino atmosphere, and I don't believe that this committee is in any kind of a mode like this. We're interested in sober assessment because the parallels, as Senator Graham mentioned a minute ago, the parallels between where we were with the FSLIC fund, 4 or 5 years ago, 4, and this, are striking.

And the respect of bank failures, there being so many more banks than there were thrifts, could be an economic disaster that would greatly really compound what we're doing now, could it not, Mr. Bowsher?

Mr. **Bowsher**. I think that's very true, Senator. In other words, the banking industry is three times as big as what the thrift industry was. And as the chairman said earlier, it's central to our whole economy.

In other words, we just cannot let this industry get into deep trouble. We've got to take timely action and the right actions, I think, to preserve this.

Senator **Shelby**. Mr. Bowsher, if we used your figures, just accept them, you've got $13 billion more or less in the FDIC fund or the Bank Insurance Fund now. And the cost of the failure of the banks that you predict will fail, is $4 to $5 billion, or $4 billion to $6 billion. And then we must add the unrealized or the delayed southwest contingent liabilities. You're just about down to here [indicating], aren't you?

Mr. **Bowsher**. No. You can't add the $8 billion to the $4 to $6 billion because the $8 billion is——

Senator **Shelby**. Contingent?

Mr. **Bowsher**. Well, it's not only contingent, but it's more of a cash draw-down, rather than what it's going to do to the equity of the fund.

In other words, a lot of the loss has been taken so far in that. But what it could do is it could hit the cash. You're absolutely right.

Senator **Shelby**. It could get there.

Mr. **Bowsher**. Yes. And, you know, all big bail-outs eventually can result in problems when the cash runs out, no matter what the rest of the accounting statement says.

So your point's well taken, that this cash flow issue is an important issue.

Senator **Shelby**. So if we have a downturn in the economy and test some markets that haven't been tested and some loans that haven't been tested, as we all know are out there, a lot of them, we're going to have a run on the Bank Insurance Fund we're going to have a broken fund, more or less.

That's what you're afraid of.

Mr. **Bowsher**. That's right. That's what we're afraid of, and that one point that I said, that if we went into a recession and had too many of these larger banks get into trouble, that we could exhaust the fund and then it would be to the taxpayer.

Senator **Shelby**. Without kidding anybody, especially the taxpayers of America, who are already paying a lot, and will pay for years on the other, what are the two best recommendations? Higher capital requirements and more assessments going into the fund?

In other words, a double hit there?

Mr. **Bowsher**. I think rebuilding the fund and rebuilding the capital of the individual banks would be among the top two.

Senator **Shelby**. But aren't we basically at a crisis management stage, that if we delay, if we're dilatory in this, we'll pay double or triple, or the taxpayer will pay forever?

Mr. **Bowsher**. Well, a lot depends on the economy. In other words, I hesitate to use the word crisis, but I think we're in a stage of I think where timely action is needed. And we should not kid ourselves that we have a worrisome situation here because we really do.

We could lose this fund just like we lost the FSLIC fund if we have any significant number of the larger banks in trouble that have to come to the FDIC for assistance.

Senator **Shelby**. And seeing that our economic expansion now is the longest, has been the longest in the history since they've been keeping records in the United States of economic activity, a lot of economists, as you well know, believe that we're going to go into a recession.

So I guess the best thing, we'd better get ready to hold the sky up, hadn't we?

Mr. **Bowsher**. I think if we took some actions, it would be very prudent, yes.

Senator **Shelby**. My time is up.

The **Chairman**. Senator Kerry, I want to accord you whatever time you may need both for an opening comment, which you've not yet had the chance to make, and then your normal question period.

Senator **Kerry**. Mr. Chairman, thank you very much. I appreciate that. I'm going to forego the opening statement and I'll just proceed to questions.

Mr. Bowsher, I guess for all of us there's a kind of ominous feeling here. Yogi Berra is very much alive today—deja vu all over again.

It's disconcerting, to say the least, particularly when I compare notes here. Let me share with you last year's testimony before this committee in October, just about a year ago. This is Bill Seidman speaking. And we've all praised him and he's done for most of our perceptions a good job across the board. But here's what he said.

> The banking industry is relatively healthy and improving, even though the level of bank failures in the Southwest is still far too high, we have continuing concerns regarding credit to developing countries and loans to finance highly leveraged transactions.
>
> All in all, however, we think bank failures will decline in 1990 and see nothing on the horizon raising any significant threat to the Bank Insurance Fund.

Now, in your testimony, you state the following today:

> Because a bank's financial condition does not deteriorate overnight, the regulatory supervision process should detect an emerging problem bank prior to its imminent failure.

And yet, here we are, in a sense, with 35 banks in great jeopardy, a thousand banks in significant jeopardy. And I think when you consider what Senator Shelby has said, which most of us agree with about the state of the national economy, it's even more troubling.

Why were the alarm bells not sounded sooner? Why are we here at this point now where it's much more difficult than one would want it to be to be able to respond?

Is the regulatory process failing?

Mr. **Bowsher**. Well, I think the regulatory process has not been getting the proper information. That's because of two or three things.

One is the accounting standards that we've talked about.

Senator **Kerry**. Right. I understand that.

Mr. **Bowsher**. So you've got to get those straightened out. Then you've got to get the regulatory supervisory people out into the field and really do an on-site examination here of all these problem banks and I think of all the large banks, because those are the two categories that are going to get you into trouble.

And I don't think you can kid yourself. When you see problem loans, you ought to recognize that that's a problem loan.

Then I think what you've got to do is you've got to make sure that that comes up through the system and gets reported.

There's a lot of people, as I said earlier, that always feel that maybe the problem will go away, or the problem won't develop. I am a great believer that if you've got a problem, you ought to report it, and then let the decision-makers worry about how to deal with it.

And so, I think that if we had not done this special study on these 200 problem banks, taking it off the thousand list there, and looking at the hundred largest banks and that, I don't think that we would have today a good knowledge of the problems that are facing us. And I think that's the kind of penetrating study that you've got to do once you get into one of these kinds of situations.

And I think also, as I've said earlier today, too, you've got to recognize that you've got greater risks to your business out there today in banking than what you did prior to 1980. In other words, banking changed in this country. Once President Nixon took us into the world capital markets again in the early 1970's, we didn't have regulation Q. We phased it out.

So, as they often say, 3-6-3, in the old days. The bankers took the money in at 3 percent, loaned it out at 6 percent, and went golfing at 3 in the afternoon.

That doesn't happen any more. In other words, this is a complicated business. Therefore, for the regulators, it's a complicated business to oversee. And they've got to have greater staff, they've got to have more talented staff, they've got to have the information flowing up properly.

Senator **KERRY**. I understand that and I sympathize with you, and even, I agree with you. But why would we now have heard previously about the accounting and the out-in-the-field aspect and so forth?

I think what is being presented to Congress now is problematical because even if we responded as fast as we responded on FIRREA, which was about 45 days, and we changed those things, the question has to be asked, given the state of the economy in the country, and the current problems with the budget, whether or not you can have an impact on the macroissues that are going to affect these banks, No. 1, and No. 2, given the experience of New England recently, I worry that what's going to come out of this is going to be a sudden re-evaluation by a lot of commercial banks of their loans, and you're going to see a lot of performing loans suddenly dubbed nonperforming and you're going to exacerbate that credit problem which it took months for people to admit existed in New England. And they finally did, but when they did, the unemployment rate was going up, the companies had shut, and the banking practices had been changed.

I see ourselves potentially getting onto a merry-go-round here, or a revolving cycle, that we don't know how to jump off of. I'm not sure that any congressional response right now—I hope it can—can adequately respond to what you've sat in front of us today.

Do you want to address that?

Mr. **BOWSHER**. Yes. Well, let me go back to the first part of your question, and that is, I think it would have been much better if this could have been brought to Congress' attention a year ago.

I think it was a recognition later on in the year. People began to realize that these real estate loans, a lot of them, a lot of the commercial loans, are not in near as good a shape as what they thought they were, or wanted to believe. And so that gets to the issues in that.

I do believe now if the Congress can act, if the regulators can act, if the Congress can get the regulators to really start to take a more realistic view in that, then you've got the information. And I think at that point, then, you can start to deal with the problem. Whether it will be something that can get out of hand, that's a danger. No question.

I think your worry is a very legitimate worry. But what I'm hoping is that today, by making this presentation as we have, that we get the congressional leadership and then the regulators and the people in the private sector, and that's an important group, doing their job in a much more realistic manner than we have in recent time.

Senator **Kerry**. You've noted in your testimony 35 banks in such severe financial condition that they may require recapitalization and assistance of some kind.

Are any of those, are any of the top 20 banks in the country among those 35?

Mr. **Bowsher**. No, no. But there are a couple of large ones in the next group of what we would call concerned banks, you might say, that are on the problem list.

Senator **Kerry**. Would any fit into——

Mr. **Bowsher**. And what I pointed out earlier is that we have quite a few banks that could literally take this whole fund.

In other words, we're down to a level of a fund that is much smaller than some individual banks in this country.

Senator **Kerry**. Does that mean that there are, some of these banks that fall into this category of the "too big to fail" section?

Mr. **Bowsher**. I would think, of some people's definition, that that would be right.

Senator **Kerry**. Mr. Chairman, I see my time is up. I don't want to——

The **Chairman**. Go right ahead.

Senator **Kerry**. Thank you, Mr. Chairman. On "Nightline" last month, Chairman Seidman was in a pretty heated exchange with Stanford economist Dan Brumbough. I don't know if you saw that at all.

Mr. **Bowsher**. I did not see that, but I know that he views it as a much more serious——

Senator **Kerry**. He has been prognosticating for sometime that we're on the edge of an abyss here.

Mr. **Bowsher**. Yes.

Senator **Kerry**. At one point, when pressed by Mr. Kopple, Mr. Seidman was asked how the American public would know if some of the biggest banks were in trouble. And his response was, "I'm telling you that when those banks are in trouble, it will be reported. It will be reported by the management, by their auditors, by the regulator, and by the marketplace."

Do you agree with that?

Mr. **Bowsher**. Well, I would hope so. But I'm not confident it will happen.

Senator **Kerry**. Doesn't today contradict that?

Mr. **Bowsher**. That's right. That's exactly right. And I think also, you've all read about the National Bank of Washington, in the newspapers, that needed assistance without ever getting on any problem list.

Senator **Kerry**. The deja vu aspect of this refers obviously to the insufficient insurance fund, to the accounting problems, and to the internal control weaknesses that we witness, all of which are similar to what we saw with the thrifts.

The thrifts also, according to both Mr. Seidman and the Attorney General, have been rampant with fraud.

Is there any indication at this point in time of any similar pattern, or do you have any fear of a similar possible problem with respect to the current fragility of our commercial banks?

Mr. **Bowsher**. In the work that we have done, we have not seen the same pattern as what you had in the S&L. But I would always warn everybody that when institutions go down and the real examination begins, lots of times, it will never surprise me that you'll see some fraud.

But I would not expect it to be of the magnitude that we saw in the S&L's. But that's not based on any study. I'm just giving you kind of a personal opinion there.

Senator **Kerry**. Also, there was a very significant asset base overvaluation because of the real estate, the significance of the real estate investments to the portfolios of the thrifts.

Is there any similar asset based overvaluation or dependency within, or is there a difference in the asset base of——

Mr. **Bowsher**. I think you've got a lot of similarity in that problem, and these appraisals and how much are they worth and everything like that.

So I don't think there's a large difference in that.

Senator **Kerry**. I think the staff has informed me that perhaps the chairman asked something about this at the outset on the question of real estate valuation.

Do you have any opinion as to whether or not, if the Congress were to deal with some aspects of real estate transactions, either through allowance for certain losses or for certain kinds of investments, at least for active partners or so forth, would that have a different in revaluing some of these assets and in assisting some of these banks to make it over the capital requirement hunt?

Mr. **Bowsher**. We'd better give that some thought and get back to you for the record, I think.

Senator **Kerry**. OK. Well, I would appreciate it if you would.

Mr. Chairman, I don't want to ask any more questions now. I really want to congratulate you for holding this hearing and the hearings that you have slated on this subject.

I think that the public is obviously concerned about Iraq and we've got an awful lot of issues on the table. But as you know, in our discussions that we've had privately over the course of the last months, there really isn't any issue more important for the country today than our current financial services structure and our economy, fundamentally, which is in, I think, great jeopardy. And I think even more significantly, as a consequence of these kinds of problems that have been laid on the table.

It seems to me that the budget fix and all of these things are far, far more important in terms of working this out than the things that we ought to do and we ought to proceed on them rapidly. But I have this feeling that they won't have an iota of the impact that those larger issues are going to have.

Mr. **Bowsher**. I think that's a very important statement there, Mr. Chairman.

We're going to issue another report later this week that is going to be just as pessimistic on the budget, the Federal budget. But we're coming with options here. We've been requested by several Senators to do this work.

I think that issue and this issue are the two issues that the country really has to address here in the near future.

Senator **Kerry**. Well, Mr. Chairman, this is the work that the Banking Committee ought to be doing. I applaud you for engaging in it. I think that we ought to be—I don't mean this disparagingly—but I've seen enough of these statements and I harken back to the 1988 statements of Danny Wall telling us, no, it's a $15 billion problem and we don't need any help.

If we haven't learned by now to be suspect of those kinds of statements and to look behind and to look underneath the stones, then we haven't learned very much. I think this committee has its work cut out for it to try to get a handle on this.

The **Chairman**. I might just say, before we go back to Senator Graham, that the situation in Iraq and Saudi Arabia, will be an expensive operation. It may prove to be expensive in lives and it certainly is expensive in terms of dollars.

We're not finding much help out there. We're not finding our traditional allies wanting to suit up and to put their people out on the sand dunes with ours, and that's very disturbing to me.

Nor are we finding much evidence of wanting to share in the cost side of this. I think the response of Japan in this area is particularly disturbing.

If the United States is going to undertake not only to pay our share of the cost out there, but most other people's share as well, I object to that. But if we are going to do it, then we must have the financial strength to do it.

Mr. **Bowsher**. That's right.

The **Chairman**. And that means that we must protect the economic base of this country. You're going to be coming forward later this week with some very distressing findings and observations about the structural Federal budget deficit. The deficit has implications for higher interest rates because we have to rely so much on borrowed capital from around the world. It also places additional stress on our economy and on our financial structure. Add to this the problem that you've outlined today—the fact that we're down now to a paper-thin margin in the Bank Insurance Fund. If we are honest, doing up-to-date accounting based on the true economic facts today, there may not be any surplus in the fund today.

To be that close to broke on an issue that's that fundamental to the centerpiece of our economic system, is something that must be dealt with immediately. This is not a second-tier priority or a third-tier priority. If we don't keep the economic structure solidly in place, we will not be able to project ourselves around the world on the scale that we might otherwise feel necessary.

So, if we want to be strong overseas, we'd better make sure that we're strong here at home.

Mr. **Bowsher**. Absolutely.

The **Chairman**. And in economic and financial terms, there's no lasting strength that isn't rooted in economic foundations.

You have told us here that we've got major, major structural problems. You have given us a very serious warning that we must take steps to deal with this problem and that we cannot afford to put off that action.

Is that a fair summary of what I'm hearing from you?

Mr. **Bowsher**. That's a very good summary.

The **Chairman**. Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman. I just have a couple of questions left which relate to the immediate agenda for Congress.

The administration has submitted its recommendation of staff resources for the various regulatory agencies. Could you comment as to whether you think they are sufficient in terms of numbers and the likelihood of attracting the quality of personnel to carry out the tasks that you think lies before them?

Mr. **Bowsher**. We could do that, Senator. I'll give you one preliminary viewpoint, and that is that they're raiding our staff at a tremendous rate. So that the higher salaries are helping them, without any question. It's not helping us.

Senator **Graham**. So you think maybe we've overcompensated?

Mr. **Bowsher**. Right. Or maybe I can get my team up there.

Senator **Graham**. I'd be interested if you would look at this issue, since that's one of the immediate things that we're going to have to be dealing with in the budgetary process.

Mr. **Bowsher**. Yes, we'd be happy to.

GAO is beginning a comprehensive review of the examination and supervision process for banks and savings and loans. In performing this review, one of our objectives will be to determine whether the Federal regulatory agencies have sufficient staffing resources to effectively monitor financial institutions and to intervene on a timely basis to prevent the further deterioration of a problem institution.

Senator **Graham**. The second question, and we keep going back to 1988. Today is September 11, 1990. Almost exactly 2 years ago, on September 8, 1988, Mr. Wall, then the Chairman of the Home Loan Bank Board, testified before this committee. And in response to the question, "Is there anything that the Congress should be doing relative to the thrift industry?," he stated:

> I believe that in the past year, the FSLIC has made significant strides in resolving FSLIC cases and, though subject to the vagaries of future economic conditions, realistic projections today indicate that FSLIC possesses adequate resources in the near term to deal effectively with the immediate problems of troubled institutions.

At or shortly after that date in September, the Home Loan Bank Board began to engage in a number of transactions, many of which have now been the subject of hearings before this committee, before the judiciary committee, before the House committee. And an explanation for those exotic transactions was that the fund didn't have enough money to deal with the problems; therefore, they had no choice but to engage in the financial highwire acts of the fall of 1988.

I guess my question is——

Mr. **Bowsher**. If you remember, Senator, I think those testimonies were some of the worst I've seen in 20 years here in Washington, because if you remember, in December, he then came forward and said, oh, by the way, we've now done some deals and it's going to cost $38 billion on a present-value basis, and it was going to be $60 billion.

Senator **Graham**. Right.

Mr. **Bowsher**. And I can remember one of you asking me, could anybody, the Secretary of Defense, commit the American taxpayer for that kind of money? And, of course, no.

It was an incredible thing, to go from September to December and say in September that we didn't have any problems, but, boy, in December, we were setting all kinds of new records for what the problem was.

The **Chairman**. Well, would you just yield on that point? There's a record on this. It's a clear record of members of this committee asking—requiring—you to dig into those details. We talked about it and sent you another letter right at the end of the year. That was before most of these deals were consummated. We asked you to get into the details right then, before any of the information was discarded or lost.

And you did do that.

Mr. **Bowsher**. That's correct.

The **Chairman**. You and others on this committee felt apprehension about the actions that were taken on at the time. But that still did not change the outcome.

Senator **Graham**. Those comments were the predicate for this question.

The statements made yesterday relative to forbearance being considered as an option for FDIC raises the prospect that we may be falling into that pattern again; that is, the regulatory agencies, the insurance funds, taking actions that are not prudent because of their limited options in large part because of the limited resources available in the insurance fund.

Do you see any pattern of those activities emerging now?

Mr. **Bowsher**. I definitely see a pattern. I want to study it more, as I said to Senator Garn. But it really worries me and I think it gets back to our budgeting problem and Gramm-Rudman.

In other words, I think that we have a situation here that we've got ourselves into such a large budget deficit, that everybody's always trying to put the problem off. And instead of dealing with the problem, we get into that pattern. That's what really worries me. It just has a ring of familiarity of 2 years and 3 years ago on the FSLIC thing as to why now we have a better approach here to handle this.

Oh, by the way—it also doesn't require budget resources. So I'm going to be looking at this very carefully.

Senator **Graham**. Well, while you're looking at it, I'd like you to have this next question in mind.

Mr. **Bowsher**. All right.

Senator **Graham**. And that is, should we be considering an infusion to the FDIC fund at this time in order to get it to a level that does not create the sort of temptations to take risky actions because of the paucity of the fund?

Mr. **Bowsher**. All right. We'll do that.

Senator **Graham**. You wouldn't care to comment on that now?

Mr. **Bowsher**. I wouldn't want to make any estimate now. But I certainly think it's worth looking at and we were planning to do that.

Senator **Graham**. In terms of things that the Congress could do on an immediate basis, one thing we could do is to provide some short-term infusion to the fund in order to give it sufficient strength that it did not attempt——

Mr. **Bowsher**. It could deal with the problems.

Senator **Graham** [continuing]. Risky actions.

Mr. **Bowsher**. That's right.

Senator **Graham**. Thank you.

The **Chairman**. Senator Graham, I appreciate very much what you've just covered.

I want to just say a couple of other things in conclusion here. First of all, this subject will be explored again tomorrow from another independent vantage point. We will have the Congressional Budget Office in here to talk on this subject that will help lay out the issues further.

I'm also concerned about what you will present later in the week onto the deteriorating condition of the Federal budget deficit.

I have a strong feeling that problem has a lot of the same elements. We've had phony accounting, failure to recognize the true costs, and putting a lot of things off-budget.

I suspect that a scrub-down of our Federal deficit is going to show a deficit worse than what is reported.

One of the biggest aspects is that we use the Social Security Trust Fund to hide the true size of the deficit. That is probably the most visible and understandable deception.

Quite apart from that, take the off-budget items, the unrecognized exposures, the costs that are embedded but deferred, and the liabilities that are unrecognized because of accounting gimmicks. Then, you have, in some important measure, a parallel to what we've seen previously in the S&L problem and what you are now seeing in the banking industry.

It is conceivable—and it would not surprise me if we well have a Federal budget deficit that is $50 to $100 billion higher than it is stated to be. Maybe even more than that.

This raises a still larger question about the economic and financial stress we are facing.

The United States has got to make a major adjustment. It has to make a series of adjustments in its economic policies. It has to work back through its Federal budget and fiscal strategies. We cannot rely on the Federal Reserve Board to wave a wand or push a magic button to resolve these problems with low interest rates or some other way to solve all these other problems.

That won't do it. That option is not available to us. The Congress and the Federal Government, not just this committee, must get this issue, this whole set of questions, into focus.

The American people rely on us to cut through the complexity, get an accurate and honest picture of the problem, and then set it right.

I'm confident that people will support the steps that are needed to set things right. Our problem will not be in that area. The American people want to do, and will do, what is required to get us on a sound footing.

Our problem today is that it is not yet clear what is the full magnitude of the problem and what are the adjustments that are needed.

We have got a lot of work to do and have not got a lot of time left to get it done.

Any final comment from you, Mr. Bowsher, or Senator Graham, before we conclude?

Mr. BOWSHER. No, Mr. Chairman. I feel this has been a very good hearing and I appreciate very much the opportunity to present this to you.

The CHAIRMAN. Thank you very much for coming. You've done an excellent job, as have your people. As always, we thank you and we appreciate very much your professionalism.

Mr. BOWSHER. Thank you.

The CHAIRMAN. Thank you. The committee stands in recess.

[Whereupon, at 12:07 p.m., the committee was recessed.]

OVERSIGHT HEARINGS ON THE CONDITION OF THE BANK INSURANCE FUND

WEDNESDAY, SEPTEMBER 12, 1990

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The committee met at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Donald W. Riegle, Jr. (chairman of the committee), presiding.

Present: Senators Riegle, Dixon, Shelby, Dodd, Graham, Garn, Heinz, D'Amato, Pressler, and Bond.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. The committee will come to order.

Let me welcome those in attendance this morning, and very particularly, the witnesses I will be introducing later.

Today, the Banking Committee convenes its second hearing on the condition of the Bank Insurance Fund. And as most of you here would know, yesterday, we heard from the Comptroller General of the United States, Mr. Charles Bowsher. His testimony amply confirmed earlier statements of FDIC Chairman William Seidman that the Bank Insurance Fund is under significant stress at this time. Those stresses appear to be increasing.

Our first witness today is Robert Reischauer, who is Director of the Congressional Budget Office. At my request, the Congressional Budget Office has prepared its own analysis of the condition of the Bank Insurance Fund, together with a 5-year projection of demands on the fund and the fund's cash balance.

CBO's analysis provides yet further confirmation that the condition of the Bank Insurance Fund is precarious at this time. Despite statutory requirements that the fund maintain a balance equal to 1.25 percent of insured deposits, CBO projects the fund will decline to 0.4 percent of insured deposits by 1993.

But it's important to note that CBO's testimony also states that there is "no significant likelihood" that the 1.25 percent target can be attained by 1995 without further increases in assessment rates.

So these are distressing conclusions. Behind all that, too, stand an analysis of what's likely to happen to the economy in general. We'll get into that today because, obviously, a more adverse economic climate will cause other problems and a more rapid erosion of the remaining balance in the insurance fund.

So these are distressing conclusions. More troubling still is the economic assumptions that underlie CBO's conclusions. They appear, to me, to be quite optimistic, even though it's hard to find anybody who is terribly optimistic about the outlook for the economy at the present time.

So we will be interested in inquiring of Mr. Reischauer whether CBO has prepared any analysis indicating how severe a recession our economy could sustain before the Bank Insurance Fund would become insolvent.

Our second panel of witnesses today consists of two commercial banking experts. Michael DeStefano is a banking industry analyst from Standard and Poor's. And Robert Eisenbeis of the University of North Carolina at Chapel Hill is an academic expert on the commercial banking industry.

Both of these individuals will be offering the committee valuable insights into the current condition of the banking industry and its outlook for the years ahead.

Now let me also say this, and I want to underscore this. Based on GAO's testimony and CBO's written statement that we have before us and will be inquiring about today, I think that it would be a mistake for Congress to adjourn this fall without ensuring that the FDIC has whatever authority it needs to raise assessment premiums. I hope such increases will not be needed, but Congress' first priority must be to protect the Bank Insurance Fund and the taxpayers that stand behind it.

So last night I instructed the Banking Committee staff to begin drafting a simple piece of legislation to give the FDIC that authority. And I want to invite my colleagues who participated yesterday and expressed similar concern, invite them to review this draft when it's completed—I expect that will be later this morning—and join me in cosponsoring it.

Having said that, let me welcome all of our witnesses to the Banking Committee this morning. We look forward to hearing from them.

Let me yield now to Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Thank you, Mr. Chairman.

At yesterday's hearing, Comptroller General Bowsher gave this committee a very sobering statement on the health of the Bank Insurance Fund. I asked Mr. Bowsher if he thought there were any legislative actions that needed to be taken by Congress this year before we adjourn to shore up the fund. And I trust that today's witnesses will tell us if they see actions that are needed to be taken before we adjourn as well.

I suggested to Mr. Bowsher that obviously we couldn't make any overall general changes in the insurance fund or overall reform this year, but I asked him if he would give the committee a list of shorter term actions that we could take.

I would ask you gentlemen to do the same thing for us, things that are politically and time-wise possible to do before we adjourn.

Today, we continue our examination of the Bank Insurance Fund and we expand the scope of these hearings to include a look at the structure of the insured institutions. I certainly believe that this is appropriate, for no matter how high we raise the deposit insurance premiums, we will not have healthy deposit insurance funds over the long haul unless the insured industries are healthy.

In this regard, I would draw particular attention to the comment in Professor Eisenbeis's statement regarding the dangers of forcing depositories to overly concentrate their lending in a single area such as real estate. It is not enough to point out that the assets of the commercial banking system have become riskier in recent years. We must understand why they have become riskier.

It is not enough to conclude that our depository institutions have not built up a sufficient capital base; we must also determine what has prevented these institutions from raising the necessary capital.

It is not enough to demonstrate that the credit rating of our financial institutions had declined in recent years; we must find out also what legislative actions are necessary to enable these institutions to respond to the evolving markets and become healthy competitors again.

Action on these broader issues almost certainly will not be possible this year, as I mentioned. Still, we need to do all we can to lay the groundwork for what I hope will be far-reaching, constructive, reform legislation in the area of deposit insurance next year.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Garn.

I want to associate myself with the remarks that you've just made. We very much need to and are in the process as a committee of deciding how the financial services industry ought to be restructured, what the banking franchise ought to look like, how we should do the accounting, what the capital standards should be, and so forth.

And I would hope that before this session is over, we will be able to develop these aspects that relate to deposit insurance reform. I will circulate a draft among committee members and develop a legislative package that I will want to cosponsor with as many members of the committee on both sides as we can attract.

There may be some differences in viewpoints that would cause some to want to have a measure of their own, but my hope would be that we could have one bill.

And I'd just say further on the broader questions of how we ought to restructure the business franchise and permit related financial institution activities in the future, that our hearing schedule this year has given us the foundation of expert testimony and analysis that puts us in a strong position now to come to some conclusions.

This committee ought, in conjunction with the administration, to develop a comprehensive package in this area. It ought to come early next year so that we get it done ahead of the Presidential reelection cycle that tends to start to sweep major legislation aside as we get closer to the election.

Next year is the year that gives us a window with which to work. We have been preparing ourselves so that we can get ahead of this curve, get ahead of the curve on the FDIC insurance fund problem, get ahead of the curve on the fundamental questions you raise about how should the industry be structured and how should the franchise look in the future.

So, with that, let me yield to Senator Shelby. I know you have a strong interest in these matters, too.

Senator **Shelby**. Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR SHELBY

Senator **Shelby**. First of all, Mr. Chairman, I want to commend you for the series of hearings that you've scheduled and for the excellent panelists that you've brought before this committee.

I believe that it is this committee's responsibility to try to prevent any possible disaster from coming on down the road. Of course we hope that won't occur, but the testimony yesterday, as Senator Garn said, was both sobering and candid.

I don't believe there's a member of the Banking Committee or a Member of the Congress that wants to see the banking system experience anything like the thrifts did. But from the testimony yesterday, it is possible that, we're not far off.

There are a couple of things that have bothered me. First, there are the accounting rules. Do they need to be changed, for a more realistic picture of what conditions some of the banks really are in?

The second thing is, what is the state of the economy; what is a slow economy going to do to a lot of these banks?

The first thing it's going to do is, as you gentlemen here know, is test the strength of banks' portfolios. It always does. And if it's a real down economy, looking at the financial problems of the Bank Insurance Fund, we got real problems.

I was here in 1987 when people, not from the banking industry, but the thrift industry, came forth and said, we don't need but just a little bit of money. A little bit will take care of it, whatever the figure was, $5, $6, $7 billion. It turns out that was just the tip of the iceberg.

I hope we're not just seeing the tip of the iceberg here. I hope we will not whitewash this in any way because we have a greater responsibility, Mr. Chairman.

The **Chairman**. Thank you, Senator Shelby.

Senator D'Amato.

Senator **D'Amato**. Mr. Chairman, I have no opening statement.

The **Chairman**. Very good. So ordered.

Senator Graham.

OPENING STATEMENT OF SENATOR GRAHAM

Senator **Graham**. Thank you, Mr. Chairman.

I, too, want to join the remarks in commending you for holding this series of hearings. I do not have a prepared opening statement, but in light of what we heard yesterday, would like to offer a few comments.

One is that I sense the urgency of this issue. And I believe that it's very important that we follow your lead in taking action or presenting to our colleagues a plan of action in the days between now and when this session of Congress adjourns.

Second, I sadly have concluded that we cannot rely upon the normal relationship with the regulators to give us their direction as to what we should do. I feel very burned about what happened in 1988, when representations were made as to the state of the thrift industry. Based on those representations, we took a position of acceptance and therefore, passivity, and have paid a very heavy price for that.

I believe it's our responsibility as members of this committee and as Members of the Congress to act based on our own assessment of the situation and not again be led to inaction by representations of the regulators.

Third, in order for us to act effectively, it's going to require that we have better information than we currently have.

So one of the questions that I'm going to be asking of our witnesses today is what information should the Congress have through the CBO, other entities or directly to the committees in order that we could be in a position to make independent assessments of the need to act.

And finally, Mr. Chairman, I was concerned about the repeated statements yesterday at the inadequacy of the information base upon which a whole chain of decisions in financial regulatory entities were being made.

I would be very interested in our discussions with the representatives of the rating agencies as to how they go about assessing, massaging, utilizing information that's available to them for purposes of the decisions that they have to make and information that they provide to their clients.

I think that this is going to be an extremely instructive hearing today. I appreciate your calling it, Mr. Chairman, and look forward to the witnesses.

The CHAIRMAN. I appreciate your comments and suggestions about the steps we ought to take. I concur in what you've said.

When you have banks that don't show up as problem banks that can fail overnight, or fail within a single quarter, you've got to ask yourself the question—what is wrong with the information normally collected that can mask severe problems when suddenly an apparently sound bank can be shut down within a matter of days or hours.

Senator Heinz.

Senator HEINZ. Mr. Chairman I ask unanimous consent that my statement appear in the record.

STATEMENT OF SENATOR HEINZ

Senator HEINZ. Mr. Chairman, I join you in welcoming the Director of CBO and today's other distinguished witnesses as we explore the health of our banking industry and its Federal deposit insurance fund. Having recently grappled with dead and dying savings and loans, it is important that we take the pulse of the more than 13,000 banks in our country.

The GAO's warning that a taxpayer bailout of the Bank Insurance Fund may be on the horizon felt like a heavy dose of shock treatment. The Bank Insurance Fund's vital signs are weak, and the banking industry is far from a picture of health.

One of the main issues raised by the Comptroller General was the reliability of our current diagnostic techniques—namely, GAAP—generally accepted accounting principles. Those principles don't appear to be well accepted by the GAO. In its view, there are some big gaps in GAAP. A number of experts recommend that we examine market values before we give any bank a clean bill of health.

In a related vein, others warn that our banks are suffering from a capital deficiency—leaving them vulnerable to a chilly economic climate. The bank regulators are prescribing strong capital supplements and an adjustment of the minimum daily requirements. For many banks, this strong medicine may be hard to swallow.

Mr. Chairman, I look forward to today's examination. Based on yesterday's hearing I suspect that many of the most important questions will not be answered with surgical precision.

The CHAIRMAN. Very good, Senator Heinz.

Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I join my colleagues in congratulating you on holding these important hearings, and I'm pleased to be here this morning to hear from the distinguished Director of the Congressional Budget Office, Mr. Reischauer and our other witnesses on the condition of the Bank Insurance Fund and the banking industry generally.

I know the committee will benefit greatly from their testimony, Mr. Chairman.

As you know, yesterday, the committee heard from the Comptroller General. He presented a sobering GAO analysis of the problems currently facing the Bank Insurance Fund. The Congressional Budget Office analysis tends to confirm the GAO's findings. The FDIC has done the right thing by promptly raising bank insurance premiums.

However, we need to quickly examine what more should be done now. One step, Mr. Chairman, we might consider taking involves the sterile reserves the banking industry has on deposit at the Federal Reserve.

As I'm sure all my colleagues know, banks, thrifts, and credit unions currently have about $34 billion on deposit at the Federal Reserve. The great bulk of this money represents banking industry money. The Fed does not pay the depository institutions interest on these funds. However, the Fed does earn interest which it returns to the Treasury. This foregone interest represents a kind of banking industry payment to the Federal Government.

If the interest was transferred to the Bank Insurance Fund, Mr. Chairman, instead of to the Treasury, the fund would receive more than $2 billion in addition income every year, even if interest were only paid at the current Federal funds rate.

Importantly, this fund transfer could be accomplished without increasing the Federal deficit.

I again stress—without increasing the Federal deficit.

While the Fed's payment to Treasury would decrease, FDIC's income would increase, offsetting Treasury loss. The benefits of this kind of plan are considerable. It would help ensure that the FDIC has the resources it needs to close insolvent banks promptly and it would help reduce the stress on the bank fund and help reduce the possibility that the Bank Insurance Fund will need Federal general revenue assistance.

This money, in a very real sense, is already banking industry money. It makes sense to put it in the Bank Insurance Fund now. It may be one of the best investments we could ever make.

And I offer this suggestion as one the committee ought to consider very carefully. It's something we can do quickly, without adding to the deficit which would really help and it's an action that would make a real difference.

For the longer run, we also need to begin work on fundamental reform of our deposit insurance system. The fact that the bank insurance system is showing stress, even though banks are better regulated and better capitalized than thrifts, is the clearest possible demonstration of the absolute necessity for reform.

The legislation I'll introduce shortly is designed to provide an outline of the kind of reforms that will correct the flaws that currently plague our deposit insurance system.

I do not pretend that these are the only reforms that make sense. Nor would I suggest that this package can't be considerably improved.

I offer it in an effort to begin the debate and as a demonstration that Congress is very serious about reforming our deposit insurance system.

I look forward to working with you, Mr. Chairman, and my colleagues on deposit insurance reform legislation and on the other major banking law revisions that are so clearly needed right now.

The CHAIRMAN. Thank you very much, Senator Dixon. I think that is a very important suggestion that interests me and I think it will interest the committee generally.

Senator Garn.

Senator GARN. Senator Dixon, if I could just make a comment.

You've touched on a point that not many people understand. I don't know where your $2 billion came from.

Senator DIXON. It's $2.4 billion, actually, if you extrapolate it off of Federal rates.

Senator GARN. Well, just the interest, I guess. But what most people don't know is the Fed is required to be self-operating on the basis of the fees they charge and the interest they earn.

The total figure of Fed earnings is over $17 billion a year that is being charged the banking customers of this country in higher interest and higher bank fees, check-charging fees and all of that, which reduces the Federal budget deficit and that's why we hide it.

So there's a lot more than just the part you're talking about. The Fed shouldn't, in my opinion, do anything more than charge enough to pay their own fees, be self-operating. But, a year or two ago it was in excess of $17 billion. I don't know what the most recent figures are.

So there's an enormous amount of money there that is being used to disguise the Federal budget deficit.

Senator DIXON. Exactly. I appreciate my friend's comments.

Senator GARN. I commend you for bringing up the point.

Senator DIXON. The point I wanted to make, if I may only impose a second further, may I say to my good friend, the chairman, and the ranking member, and this is so important, is here's something that we could quickly do right now to put some money in that FDIC fund, instead of wringing our hands, because, if I remember our past experience, it was always when we came in to try to appropriate some money in the thrift fund, everybody wanted to work with the figures and make it a lower figure and we had all of the institutional people in here.

Here's something we could do as a committee right away to make it transfer quickly to make a difference.

I appreciate the comments of the ranking member.

The **CHAIRMAN**. You ask a valuable and interesting question whether a very meager fund balance is now inhibiting in any way the resolutions that should take place. When the fund balance gets down to too low a point, there is a natural tendency not want to go ahead and resolve problems.

So, if there is any pressure of that kind building up, then we ought to act on your idea to give the regulators the wherewithall to take actions that are needed.

So we'll certainly take that up. Before we begin, I have a statement of Senator Sanford to be inserted in the record.

[The prepared statement of Senator Sanford follows:]

PREPARED STATEMENT OF SENATOR SANFORD

Thank you, Mr. Chairman, and I thank our witnesses for being with us this morning. It is a special pleasure to welcome a North Carolinian, Robert Eisenbeis, to the Banking Committee. Professor Eisenbeis teaches at the very distinguished university from which I graduated, the University of North Carolina at Chapel Hill, and I appreciate his contributions to this hearing.

Today we take up a critical issue that we discussed yesterday with the GAO—the condition of the insurance fund that stands behind deposits in our commercial banks. As I stated yesterday, the GAO's report and some of the testimony we will be hearing this morning is most troubling. I regard it as a call for action. Many of the final recommendations and conclusions of our witnesses echo the findings of the GAO. Some of these suggestions are items we can and should act on:

No. 1, steps to ensure that on-site examinations are done on at least an annual basis at troubled and large banks;

No. 2, information gathered to ensure that bank premiums are set at a level sufficient to maintain needed reserves without unduly burdening or jeopardizing our banks;

No. 3, a further empowerment of our regulators and the FDIC to close banks or terminate their deposit insurance at an early enough stage to stem further losses to the FDIC or the taxpayers. I believe we also need to explore ways to eliminate or mitigate the so-called "too big to fail" doctrine.

While I believe these steps are prudent and could be done, I think we also need to recognize some of the positive aspects of today's testimony. As the CBO report notes, the banking industry is healthier and losses from bank failures per dollar of assets are estimated to be half of those for S&L's. Professor Eisenbeis notes that real estate oriented banks can be profitable. Mr. DeStefano states that many of our regional banks have implemented oversight controls and conservative disciplines that will strengthen those banks.

Nonetheless, these hearings are raising a number of critical issues that point to the need for reforms of our deposit insurance system as well as efforts to devise a bank regulatory system that allows our banks to be competitive in an increasingly global market.

I appreciate the thoughtful testimony of our witness and look forward to exploring many of these issues with them.

The **CHAIRMAN**. Let me now introduce the Director of the Congressional Budget Office. Mr. Reischauer, the committee and many others of us here admire the long professional career and distinguished service that your father gave to this country. We particularly respect his diplomatic service.

He was truly outstanding and you are a distinguished son following in that tradition.

Your father passed away recently. So I wanted to acknowledge the great contribution that he made and the fact that you're continuing that family tradition. We're very pleased to have you here today.

We'll make your full statement a part of the record and we welcome your summary comments.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC, ACCOMPANIED BY JAMES L. BLUM, ASSISTANT DIRECTOR FOR BUDGET ANALYSIS

Mr. REISCHAUER. Thank you, Mr. Chairman, both for your remarks about my father and for the remarks you've made about the contribution that the Congressional Budget Office [CBO] has made to the work of this committee.

I'm pleased to be here, and I'm accompanied by Jim Blum, who is——

The CHAIRMAN. I'm going to have you pull that mike a little closer because there are a lot of people in the back that won't hear you otherwise.

Mr. REISCHAUER. I'm accompanied by Jim Blum, who is the assistant director at CBO in the budget analysis division.

With your permission, I would like to submit my prepared statement for the record and summarize several aspects; namely, what CBO's views are with respect to the current condition of the Bank Insurance Fund, and some new estimates that CBO has prepared that should help this committee assess the viability of the Bank Insurance Fund over the next few years.

Let me start by reviewing, first, the metrics that have been used to evaluate the Bank Insurance Fund and, second, the historical context for CBO's new estimates.

The fund's financial condition can be assessed in one of two ways—either on an accrual basis, or on a cash basis.

The Federal Deposit Insurance Corporation [FDIC] reports its net income on an accrual basis and the resulting fund balances represent the accumulated net worth of the fund. For this purpose, the FDIC records an allowance for losses each year, both for banks that have been closed or have entered into financial assistance agreements and for those that it has identified as highly likely to fail or need assistance.

The estimated losses include the expected future income from asset dispositions, net of liquidation costs. On this basis, the fund showed a net loss of $2 billion in fiscal year 1989 and a fund balance of $14.3 billion at the end of that fiscal year.

The Federal budget, in contrast, records FDIC's transactions on a cash basis, reflecting each fiscal year only those assistance payments and receipts that have occurred. The condition of the fund can be measured correspondingly in terms of its cash or cash equivalents, largely Treasury securities which are the resources that are currently available to carry out its functions.

Using these measures, the fund incurred net outlays of $2.8 billion in fiscal year 1989 and had a cash balance totaling $15.1 billion at the end of the fiscal year.

I want to point out that cash balances are important because, in the short term, the FDIC's need for cash to finance the acquisition of assets may exceed its expected net losses by substantial amount. A shortage cash, therefore, could constrain the corporation's action.

In other words, the FDIC needs working capital that in many ways is considerably larger than the ultimate losses that it might incur.

Until 1986, the FDIC's bank insurance activities consistently generated more receipts than outlays for the Government, and the accrued balance in the FDIC fund grew steadily.

From 1970 to 1985, the insurance fund had to deal with an average of 24 bank failures a year. The total cost of resolving these problems amounted to only $22 billion over this period.

After 1985, the financial condition of the fund deteriorated substantially. Some 769 banks failed. That's about 192 a year from 1986 through 1989, and the fund's gross outlays totaled some $27 billion. The fund had net losses of $20 billion in both 1988 and 1989, and net budget outlays of $2.1 billion and $2.8 billion, respectively in those 2 years.

The fund balance as a percentage of insured deposits, which is one commonly used indicator of the fund's financial viability, was 0.8 percent at the beginning of fiscal year 1990. This figure is well below both the level that existed in 1985, which was 1.3 percent, and the target that was established by FIRREA, which is 1.25 percent.

Well, enough of the past. What's the outlook for the Bank Insurance Fund in the future? Will the fund continue to deteriorate or will it strengthen?

One answer to these questions can be found by examining CBO's baseline estimates for the Bank Insurance Fund. CBO's estimates are based on the number of institutions that are on the FDIC's problem bank list, assuming that BIF will provide assistance to failed and troubled banks in amounts that are similar to the historically high levels of assistance experienced in recent years.

The latest CBO baseline estimates were prepared in June. For an up-to-date judgment, therefore, these estimates should be modified to take account of recent developments that have changed the financial outlook of the fund.

The first of these developments is last month's announcement that the FDIC intends to raise the premiums paid by banks from the projected rate of 15 cents per $100 of insured deposit, which is what CBO used in constructing its baseline, to 19.5 cents, the maximum allowed by FIRREA for 1991.

The second development is the unexpectedly high rate of BIF spending during the first part of 1990. This rate of spending appears to exceed CBO's previous projections by as much as $1 billion.

If CBO's June baseline is adjusted to take account of these two developments, it appears that BIF's net outlays will peak at $5.3 billion in the current fiscal year and then begin to decline. By 1993, BIF will begin to show net income on an accrual basis.

Under this scenario, the fund balance would be about $12 billion by 1995, or 0.5 percent of insured deposits, still below the minimum set by FIRREA. The cash balance would be down to about $7 billion in 1995, as the FDIC would acquire increasing amounts of bank assets in the course of case resolutions.

A second method of assessing the outlook for the Bank Insurance Fund is to try to estimate BIF's contingent liabilities.

At the request of this committee, CBO developed a methodology for estimating these liabilities. This methodology incorporates the losses expected for several years ahead and considers not only failures that are highly likely to occur, which is all that is included in the FDIC's estimates, but also makes some allowance for less likely losses.

Private insurance companies use this actuarial methodology to determine their own financial condition.

To generate its own estimates, CBO sorted all the insured institutions into 5 groups, based on the ratios of equity to assets. Within each group, banks were further categorized as small, medium, or large. For each group, CBO reviewed the actual experience from 1986 to mid-1990 to assess the likelihood that an institution of a given size and capitalization ratio would fail. For each category, we then projected net losses over the 1990–93 period using these historical failure rates, along with FDIC's estimates of the loss per dollar of assets associated with such failures.

This method produced an estimate of about $21 billion in net losses that the fund will have to cover over the 1990–93 period, or somewhere between $5 and $6 billion a year. Over this period, covering these losses would require gross cash disbursements of $35 to $40 billion to finance the acquisition of assets from an estimated 600 to 700 bank failures. This estimate only slightly exceeds CBO's current baseline projection of cash disbursements over the 4 year period, which is $35 billion.

As a result, this estimate would produce lower cash balances at the end of 1993 of about $4 billion and a fund balance equivalent to 0.4 percent of insured deposits.

Of course, any estimate of future losses is uncertain. It rests heavily on the experience of the past, and the past may be a poor indicator of the future for any number of reasons, but I want to mention two.

First, the speed with which regulators close down failing institutions could change, which could increase or decrease future loss rates.

Second, and probably more important, the strength of the economy over the next 4 years will undoubtedly differ from that of the past 4 year period. CBO has not taken into account the possible effects of the slower economic growth that now seems likely.

Generally, a weaker economy would increase the likelihood of bank failures by reducing the value of bank assets, increasing loan defaults, and placing additional pressure on bank earnings.

If real estate markets throughout the Nation weakened, it would reduce the value of bank assets and would not only increase the probability that an institution could fail, but also require the Government to hold the failed bank's assets longer. This would increase the cost of resolving bank failures or assistance transactions and decrease the FDIC's revenues from the sales of the assets that it retains.

Let me conclude by noting that, while the banking industry has not reached the dire straits that the savings and loan industry is in, the potential risks are there. The Bank Insurance Fund, as you noted, is very vulnerable. The fund will have adequate resources over the next few years if losses decline from the current levels, as the two projections suggest they will. But the fund could easily run out of cash if a weaker economy or some other factor produced continued substantial losses.

The failure of one very large bank could, by itself, deplete the fund.

However, it's also important to note that both the FDIC and the Congress can affect significantly the losses that the Bank Insurance Fund will have to covered. The fund only incurs losses if institutions are closed after the real value of their assets is less than their liabilities. If systems are in place to monitor closely the financial conditions of banks and to trigger closure or mandatory disciplinary actions before significant losses occur, the fund's liabilities will be minimized.

In addition, reform of deposit insurance could provide incentives for more prudent management and thus reduce the Government's exposure to risk.

Further premium increases may be necessary. But even if premium assessments are adequate over the long run, that would not guarantee that BIF's cash resources at any given time would be sufficient.

Accordingly, it may be appropriate to increase the FDIC's borrowing authority so that it could respond rapidly to a large bank failure or to a large number of smaller failures over a short period. This would prevent a short-run cash shortage from delaying case resolutions, a practice that added substantially to the cost of the S&L bailout.

Finally, the Congress should carefully monitor the condition of the Bank Insurance Fund so that the lack of reliable information that contributed to the huge costs of the S&L bailout does not occur again.

Thank you.

[The complete prepared statement of Robert D. Reischauer follows:]

CBO TESTIMONY

Statement of
Robert D. Reischauer
Director
Congressional Budget Office

before the
Committee on Banking, Housing,
and Urban Affairs
United States Senate

September 12, 1990

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Wednesday, September 12, 1990.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Mr. Chairman, I am pleased to appear before the Committee this morning to discuss the Federal Deposit Insurance Corporation's Bank Insurance Fund (BIF). In my statement today, I will discuss the current condition of the fund and estimates we have prepared in order to assess its viability over the next few years.

The banking industry clearly is undergoing considerable stress. Close to 900 banks have been closed in the last five years, more than twice the number closed between 1934, when federal deposit insurance began, and 1979. Yet the industry as a whole is much healthier than the savings and loan (S&L) industry. Of the 13,200 commercial and savings banks at the beginning of 1990, about 11,600 are in satisfactory financial condition, with equity as a percentage of assets exceeding 6 percent. In contrast, less than half of the S&L industry attains that standard.

THE BANK INSURANCE FUND

The Bank Insurance Fund was established in 1989 by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and is operated by the Federal Deposit Insurance Corporation (FDIC). BIF replaced the bank insurance fund that the FDIC had previously operated and assumed the assets and liabilities of that fund. Like the previous fund, BIF is charged with insuring the deposits of about 13,000 institutions, of which about 95 percent are commercial banks. The fund also insures the deposits of a small number of federally and state-chartered savings banks and branches of foreign banks that conduct consumer business in this country. The responsibility for regulating the institutions insured by BIF is spread among various federal and state agencies, including state bank supervisors, the FDIC, the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Office of Thrift Supervision.

The Bank Insurance Fund spends money to pay off depositors when a bank is closed, to assist an acquiring institution when a failing bank is merged, and to cover FDIC administrative expenses. The fund derives income primarily from assessments on insured banks and from the sale of assets of failed banks. It is also credited with interest earned from its cash balances, most of which are invested in Treasury securities.

The fund's financial condition can be assessed on either an accrual or a cash basis. The FDIC reports its net income on an accrual basis, and the resulting fund balances represent the accumulated net worth of the fund. For this purpose, the corporation records an allowance for losses each year, both for banks that have been closed or have entered into financial assistance agreements and for those it has identified as highly likely to fail or need assistance. The estimated loss includes expected future income from asset disposition, net of liquidation costs. On this basis, the fund showed a net loss of $2.0 billion in fiscal year 1989 and a fund balance of $14.3 billion at the end of that year. The fund balance as a percentage of insured deposits is commonly used as an indicator of the fund's financial viability. On September 30, 1989, it was equivalent to 0.8 percent of insured deposits.

The federal budget, in contrast, records FDIC's transactions on a cash basis, reflecting each year only those assistance payments and receipts that have occurred. The condition of the fund can be measured correspondingly in term of its cash or cash equivalents, largely Treasury securities, which are the resources currently available to carry out its functions. Using these measures, the fund incurred net outlays of $2.8 billion in fiscal year 1989 and had cash and Treasury securities (a cash balance) totaling $15.1 billion. The cash balance is important because in the short term the FDIC's need for cash to finance the acquisition of assets may exceed its expected net losses by substantial amounts, and a shortage of cash could constrain the corporation's actions.

Until recently, the FDIC's bank insurance activities consistently generated more receipts than outlays for the government. From 1970 to 1985, the FDIC recorded positive net income on its books each year, including $2.8 billion in 1985. The accrued balance in the FDIC fund grew from $3.9 billion at the beginning of 1970 to $19.5 billion by the end of 1985. A total of $22 billion was spent from the insurance fund over this period, most of it after 1981, to deal with an average of 24 failing banks a year. Those costs were far exceeded by the fund's income, even after the FDIC regularly rebated a portion of the banks' assessment payments.

In the past few years, however, the financial condition of the fund has deteriorated as the industry's condition declined. In fiscal years 1986 through 1989, 769 banks failed or received assistance, and the fund's gross outlays totaled $27 billion. Spending grew steadily from $3.0 billion in 1985 to $8.6 billion in 1989. We now estimate that spending will total over $11 billion in fiscal year 1990. The fund had net losses of $2.0 billion in both 1988 and 1989, and net budget outlays of $2.1 billion and $2.8 billion, respectively, in those years. Losses and outlays in 1990 will be even greater (see Table 1).

TABLE 1. FDIC BANK INSURANCE FUND PERFORMANCE, FISCAL YEARS 1986-1990 (In billions of dollars)

	Actual				Estimated
	1986	1987	1988	1989	1990
Outlays					
Gross Spending	5.5	4.4	8.2	8.6	11.1
Collections	-4.7	-5.8	-6.1	-5.8	-5.8
Net Budget Outlays	0.8	-1.4	2.1	2.8	5.3
Net Income					
Accrued Net Income	a	-0.2	-2.0	-2.0	-3.5
End-of-Year Balances					
Cash Balance	15.9	17.1	15.6	15.1	10.2
Accrued Fund Balance	18.8	18.3	16.3	14.3	10.8

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

a. Less than $50 million.

The percentage of insured deposits covered by the balance in the fund has also declined substantially in recent years. In the 1970s and early 1980s, the fund balance covered an average of 1.2 percent of insured deposits. That ratio peaked at 1.3 percent in 1985 and has been declining since, to 0.8 percent at the beginning of fiscal year 1990. This is well below the 1.25 percent target established in FIRREA. Table 2 provides a historical perspective on the fund's activity, income, and reserves.

TABLE 2. HISTORICAL DATA ON THE BANK INSURANCE FUND, CALENDAR YEARS 1934-1989

	Average Number of Banks Closed or Assisted Per Year	Average Annual Losses on Failed Banks (Millions of dollars)	Net Fund Income (Billions of dollars)	Fund Balance as a Percentage of Insured Deposits
1934-1939	36	3	0.1	1.7
1940-1949	10	1	1.0	1.6
1950-1959	3	a	1.0	1.4
1960-1969	4	1	2.0	1.4
1970-1979	8	11	5.7	1.2
1980-1985	52	1,106	8.2	1.2
1986	145	1,859	0.3	1.1
1987	203	2,120	b	1.1
1988	221	5,509	-4.2	0.8
1989	207	5,998	-0.9	0.7

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation.

a. Less than $500,000.
b. Less than $50 million.

BASELINE PROJECTIONS FOR THE BANK INSURANCE FUND

In our June baseline estimates, CBO projected that BIF's net outlays will peak at about $4.2 billion in fiscal year 1990 and will decline gradually over the next five years, averaging about $1.5 billion a year over the 1991-1995 period. This projection was based on the number of institutions on the FDIC's problem bank list. We projected that BIF would continue to provide assistance to failed and troubled banks in amounts that are similar to the historically high levels of assistance experienced recently. These levels reflect a number of problems affecting the banking industry, including regional real estate downturns, questionable loans to developing countries, and exposure to highly leveraged transactions.

Specifically, we estimated that BIF's gross spending will total about $35 billion over the 1990-1993 period, about 30 percent more than it spent between 1986 and 1989. We also assumed that the assessment rate would remain at the minimum established by FIRREA--15.0 cents per $100 of insured deposits, beginning in January 1991. Under these assumptions, the Bank Insurance Fund would continue to show losses, the accrued balance in the fund would continue declining to about 0.3 percent of insured deposits by 1995, and the cash balances, including Treasury securities, would largely be depleted.

RECENT DEVELOPMENTS

Recent developments have changed the financial outlook for BIF. Last month, the FDIC proposed to raise the premium paid by banks to 19.5 cents per $100 of insured deposits, the maximum allowed by FIRREA for 1991. If implemented, this change would add to the fund's income and decrease its net outlays by between $1.1 billion and $1.2 billion a year, compared with our baseline projections. It also appears that BIF's 1990 spending will exceed our previous projections by as much as $1 billion. If the baseline is adjusted for these two factors, assuming that the proposed increase in bank assessments is maintained in subsequent years, we estimate that the Bank Insurance Fund would show net income (on an accrual basis) beginning in 1993 (see Table 3). Under this scenario, the fund balance would be about $12 billion by 1995, or 0.5 percent of insured deposits, still below the minimum set by FIRREA. The cash balance, however, would be down to about $7 billion in 1995, as the FDIC would acquire increasing amounts of bank assets in the course of case resolutions.

TABLE 3. FINANCIAL PROJECTIONS FOR FDIC BANK INSURANCE FUND WITH ADDITIONAL 1990 SPENDING AND HIGHER PREMIUMS
(By fiscal year, in billions of dollars)

	1990	1991	1992	1993	1994	1995
			Outlays			
Gross Spending	11.1	8.9	8.2	7.4	7.1	6.3
Collections	-5.8	-6.9	-7.3	-7.4	-7.6	-7.8
Net Budget Outlays	5.3	2.0	0.9	0	-0.5	-1.5
			Net Income			
Accrued Net Income	-3.5	-1.2	-0.2	0.4	0.8	1.5
			End-of-Year Balances			
Cash Balance	10.2	6.5	5.5	5.2	5.7	6.9
Accrued Fund Balance	10.8	9.7	9.5	9.9	10.7	12.3

SOURCE: Congressional Budget Office.

NOTE: This table represents CBO's June baseline, modified to reflect higher expected spending in 1990 and the proposed premium increase to 19.5 cents per $100 of insured deposits, beginning January 1, 1991.

A LOOK AT BIF'S CONTINGENT LIABILITIES

The FDIC currently records as contingent liabilities only those projected future costs associated with previous resolutions. It also assigns reserves for those banks that it believes are virtually certain to fail during the coming year. These items are both charged as deductions against the fund's net income.

Although these procedures may comport with standard accounting practices, a broader view would be useful for policy decisions. In assessing the contingent liabilities of the Bank Insurance Fund, it is important to estimate losses for several years ahead and not only to consider failures that are highly likely to occur, but also to make allowance for less likely losses. (Private insurance companies prepare such projections on an actuarial basis to determine their own financial condition.) Surprises cannot be ruled out; institutions that appear to be well capitalized can and do fail, even within one or two quarters.

While CBO is not privy to the kind of detailed financial information available to the FDIC, we have analyzed the available industry data to develop an estimate of the fund's potential liabilities over the next few years. We sorted all the insured institutions into five groups, based on the ratios of equity to assets. Banks within each group were categorized as small, medium, or large. For each group, we reviewed actual experience from 1986 to mid-1990 to assess the likelihood that an institution in a given size category would fail over a period of 3 1/2 years. For each category, we then projected net losses over the 1990-1993 period using these historical failure rates, along with FDIC's estimates of the loss per dollar of assets associated with those failures. (The historical information is summarized in Table 4 and the projections in Table 5.)

TABLE 4. BANK FAILURES AND LOSSES OVER THE 1987-1990 PERIOD, BY CAPITALIZATION AND SIZE OF BANKS

	Number of FDIC-Insured Banks 1986	Bank Failures Between 1/1/87 and 6/30/90	Assets of Failed Banks as Percentage of Total Assets in Size Category	Estimated Losses as Percentage of Assets at Failed Banks in Size Category
Group 1				
Large banks	271	8	1.5	7.4
Medium banks	1,694	23	1.6	20.8
Small banks	9,945	278	2.3	24.9
Total	11,910	309		
Group 2				
Large banks	279	16	3.5	10.6
Medium banks	523	60	11.2	15.8
Small banks	1,195	175	12.7	22.7
Total	1,997	251		
Group 3				
Large banks	4	0	0	0
Medium banks	19	12	53.1	11.1
Small banks	113	67	55.7	17.3
Total	136	79		
Group 4				
Large banks	2	1	21.7	24.4
Medium banks	9	5	68.7	28.8
Small banks	73	42	55.5	26.3
Total	84	48		
Group 5				
Large banks	2	2	100.0	8.9
Medium banks	2	2	100.0	35.0
Small banks	45	43	97.2	31.4
Total	49	47		
Total, All Groups	14,176	734	3.7	14.0

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped by equity as a percentage of assets, as follows:

Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of more than $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

Revised

TABLE 5. PROJECTION OF 1990-1993 BIF LOSSES BASED ON 1986-1989 EXPERIENCE

	Number of Insured Banks 12/31/89	Total Assets 12/31/89 (Billions of dollars)	Projected Number of Failures 1990-1993	Projected Fund Losses 1990-1993 (Billions of dollars)[a]
Group 1				
Large banks	479	1,030	14	1.1
Medium banks	2,231	435	31	1.4
Small banks	8,931	338	250	1.9
Total	11,641	1,803	295	4.5
Group 2				
Large banks	228	1,505	13	5.6
Medium banks	330	72	38	1.3
Small banks	743	29	108	0.8
Total	1,301	1,606	159	7.7
Group 3				
Large banks	8	66	5	2.1
Medium banks	15	3	9	0.2
Small banks	84	3	49	0.2
Total	107	72	63	2.5
Group 4				
Large banks	5	35	3	1.8
Medium banks	10	3	6	0.3
Small banks	55	2	31	0.2
Total	70	40	40	2.3
Group 5				
Large banks	6	21	6	2.8
Medium banks	8	2	8	0.5
Small banks	63	2	60	0.6
Total	77	25	74	3.9
Total, All Groups	11,641	3,545	631	20.8

SOURCE: Congressional Budget Office based on data from the Federal Deposit Insurance Corporation and Ferguson and Co.

NOTES: The banks are grouped as follows:

	Equity as Percentage of Assets
Group 1	Greater than 6 percent
Group 2	Greater than 3 percent, but less than or equal to 6 percent
Group 3	Greater than 1.5 percent, but less than or equal to 3 percent
Group 4	Greater than zero percent, but less than or equal to 1.5 percent
Group 5	Less than or equal to zero percent

Banks with assets of more than $500 million are categorized as large; banks with assets greater than $100 million and less than $500 million are categorized as medium; banks with assets of $100 million or less are categorized as small.

[a] For each category, this is calculated by multiplying total 1989 assets of insured banks (from this table) times assets of failed banks as a percentage of total assets (from Table 4) times estimated losses as a percentage of assets at failed banks (from Table 4).

As an example of how these projections were made, we can look at the 271 large banks with equity-to-asset ratios of 6 percent or more in 1986--the best-capitalized institutions. Eight of these, accounting for 1.5 percent of the assets in their category, had failed between 1986 and mid-1990. The FDIC has estimated its losses on these banks to be 7.4 percent of assets. Applying these rates to the $1.0 trillion in assets in that class of institutions at the end of 1989 yields projected net losses over the next few years of $1.1 billion for such banks. We carried out similar projections for each of the other categories. The probabilities of failure are much higher in other groups, rising to 29 percent for banks with equity-to-asset ratios between 1.5 percent and 3.0 percent, and to 100 percent for those with no equity at all.

This method produces an estimate of about $21 billion in net losses to be covered by the fund over the 1990-1993 period, or $5 billion to $6 billion a year, from a total of 600 to 700 bank failures. (The FDIC had about 1,100 commercial banks on its problem list as of December 31, 1989.) Over the 1990-1993 period, covering these losses would require gross cash disbursements of $35 billion to $40 billion to finance the acquisition of assets from failed banks. (This would be below the rate of spending we currently expect for fiscal year 1990.) This estimate only slightly exceeds the current CBO baseline projection of cash disbursements over the four-year period, which is $35 billion. As a result, by 1993 it would produce lower cash balances–of about $4 billion–and a fund balance equivalent to 0.4 percent of insured deposits.

Most of this risk is associated with large banks, those with assets of at least $500 million. Only 50 to 60 such banks would account for two-thirds of these losses. If just one of the 10 largest banks fails, it alone could account for losses of $10 billion or more. While failure of one of these very large banks may be unlikely, it is certainly possible. Only 2 of the top 10 banks report equity-to-asset ratios that exceed 6 percent. These 10 institutions hold more than $43 billion in debt from developing countries, as well as substantial amounts of questionable commercial real estate loans, highly leveraged debt, and nonperforming or delinquent loans.

Of course, any estimate of future losses is very uncertain. There is no assurance that future experience will match recent history or that the FDIC's estimates of losses already incurred will turn out to be accurate. Future loss rates could be higher or lower than past ones, depending on how quickly regulators move to close down failing institutions. In addition, CBO has not taken into account the possible effects of the slower economic growth that now seems likely. The uncertain economic outlook, exacerbated by declines in real estate values and sharp increases in oil prices, raises concerns that spending from the fund could be greater during the next few years than we have estimated. However, the impact of economic conditions on the fund is difficult to quantify. Generally, a weaker economy would increase the likelihood of bank failures by reducing the value of bank assets, increasing loan defaults, and placing additional pressure on bank earnings. More specifically, the spread of current problems in some regions to real estate markets throughout the nation would reduce the value of these assets and would not only increase the probability that an institution could fail, but also require the government to hold the failed bank's assets longer. This would increase the cost of resolving bank failures or assistance transactions and decrease the FDIC's revenues from the sale of the assets that it retains.

If losses as a percentage of assets were twice the estimated historical rate, and thus similar to S&L losses, the estimate would double. And if the probabilities of failure were changed by as little as 0.5 percentage points, well within the range of uncertainty, the estimate of losses would swing by more than $2 billion.

These loss projections do not include additional potential liabilities of the fund that could result from previous case resolutions. The FDIC has guaranteed in various ways the value of assets transferred to certain acquiring institutions. These commitments could require additional cash outlays by the fund in future years. According to the FDIC, this potential exposure is about $8 billion.

CAN BIF ATTAIN ADEQUATE RESERVES?

No one can predict with certainty the amount of the fund's losses over the next few years. The possible magnitudes range from quite small to very large, with a small likelihood attached to the two extremes and a much greater probability of losses somewhere in between. The losses will be affected by international events, national economic factors, regional conditions, the actions of regulators, and a host of other circumstances. It would not be reasonable or possible to accumulate sufficient reserves to cover the full cost of catastrophic losses, but the government must decide, either explicitly or otherwise, what level of losses the fund should be able to meet from its assessment income and other resources. In FIRREA, the Congress stated that BIF should have reserves of at least 1.25 percent of insured deposits. We estimate that the fund would require a balance of $30 billion by the end of fiscal year 1995 to meet this target, but that it cannot be attained in the next few years without further increases in bank assessment rates.

FIRREA allows the FDIC to increase the rate for assessments charged to insured banks by up to 7.5 cents each year, to a maximum level of 32.5 cents per $100 of insured deposits. As I noted earlier, the agency has proposed an increase of the full 7.5 cents for calendar year 1991. Premiums at the proposed level of 19.5 cents would generate enough cash to finance annual gross expenditures of $7 billion to $8 billion a year, which could cover insurance losses of $4 billion to $5 billion annually. This income would be less than the expenditures necessary to finance FDIC activity through 1993 under both the June baseline assumptions and our actuarial-type estimate of $21 billion in net losses over the 1990-1993 period. As a result, cash balances would decline over this period in both cases, even with the higher premiums. Under baseline assumptions, outlays in later years would decline, and the fund's receipts would begin to exceed its expenditures. In neither case would the fund balance attain the 1.25 percent target.

If the FDIC were to continue to raise the rate as quickly as possible, reaching the maximum by 1993, the fund balance (on an accrual basis) would reach $27 billion in 1995, or 1.1 percent of insured deposits, under baseline spending assumptions. Under our actuarial-type estimate, the balances of the fund would be slightly lower. These estimates assume no change in the projected deposit base or in the number and cost of bank failures as the result of the change in the assessment rate. They also would require that the FDIC be authorized to raise assessment rates when the fund balance is increasing as a percentage of insured deposits, which cannot be done under current law. Of course, substantially higher premium assessments would erode bank profits. This could well threaten the viability of additional institutions, adding to BIF's case resolution costs and diminishing the assessment base.

Even the 1.25 percent reserve target, which was typical of the fund's status in the 1970s and early 1980s, may not be sufficient to cover BIF's needs over the next few years. While such a reserve is likely to be sufficient to cover losses incurred by the fund, it might not provide adequate cash resources if much of the fund balance comprises illiquid assets.

CONCLUSION

The banking industry has not reached the dire straits of the savings and loan industry, but the potential risks are there. The industry as a whole is healthier, and losses from bank failures per dollar of assets are estimated to be half those for S&Ls. Nevertheless, the Bank Insurance Fund is very vulnerable. It will have adequate funds over the next few years if losses decline from current levels, but could easily run out of cash if a weaker economy or other factors produce continued substantial losses. The failure of one of the very large banks could, by itself, deplete the fund.

Both the FDIC and the Congress can affect significantly the losses that will have to be covered by BIF. The fund only incurs losses if institutions are closed after the real value of their assets is less than their liabilities. If systems are in place to monitor closely the financial condition of banks and to trigger closure or mandatory disciplinary actions before significant losses occur, the fund's liabilities will be minimized. In addition, reform of deposit insurance may provide incentives for more prudent management and thus reduce the government's exposure to risk.

Further premium increases may be necessary. But even if premium assessments are adequate over the long term, that would not guarantee that BIF's cash resources at any given time would be sufficient. Accordingly, it may be appropriate to increase the FDIC's borrowing authority so that it could respond rapidly to a large bank failure or to a large number of smaller failures over a short period. This would prevent a short-run cash shortage from delaying case resolutions, a practice that added substantially to the costs of the S&L bailout.

Finally, it is important that the Congress carefully monitor the condition of the Bank Insurance Fund, so that the lack of reliable information that contributed to the huge cost of the savings and loan bailout will not occur again. In particular, it would be useful for the FDIC to provide information about how actual realized losses over time compare with the original estimates of losses that are made when institutions are closed or merged. Also, it would be helpful to know more about the supervisory ratings of banks, in order to assess accurately the potential liabilities of the fund. To make the appropriate policy judgments, the Congress and the public should have estimates of all potential losses, not just those already incurred or certain to be incurred in a short time. The estimates should encompass the full scope of possible failures and account for the possibility that both big banks and apparently healthy banks fail.

The CHAIRMAN. Thank you. With respect to your last sentence, that's exactly what we've endeavoring to do. That is, we are trying to understand the situation and its dynamics while we still have some time to act. We are trying to anticipate situations that may arise and have in place ways of heading them off, or dealing with them.

Let me ask you several questions here.

First of all, as we have been listening to other expert witnesses who have said that the accounting data we're relying on can be misleading. It can be out of date and not represent true market value today.

We have seen a sharp drop in real estate values in such a short time in many areas of the country.

Based on the work that you've done, can you assure as that, if we were to do a market value accounting, to mark assets to today's prices that we're not looking at a number of insolvencies, large banks, small banks, or some combination that would exhaust this fund?

Can you certify that today, we do not face this situation?

Mr. REISCHAUER. No, I can't. As you know, we don't have the market value of assets on a current basis, so we do not know what land mines might lie out there. That's one of the needs that I think we have, and that is one reason why, as the Comptroller General mentioned yesterday and you mentioned in your opening remarks, banks that are not on the problem bank list can suddenly appear as major problems in a short period of time.

There's also the whole issue of the volatility of the economy. As we've seen in the last 2 months, situations can change quite markedly in the Nation as a whole and in certain regions.

The CHAIRMAN. Even yesterday, when we had the Comptroller General here, certified the balances as of the end of last year.

Now, we're in September of this year. So 9 months have passed. There have been additions and deletions from the insurance fund. So the true working balance today?

The dynamic change that's going on in the economy is looming over us. Values reported in bank balance sheets may be misleading. An asset may show up at a certain value that is no longer valid because of the sharp drop in real estate values that is spread over much of the country.

I don't say that to be alarmist. I simply state what I see happening, what is being reported to us.

I am concerned that our measurement system is always late. By its very nature, it is late. Our current knowledge of the fund balance is already 9 months old.

The windfall drop in real estate values, commercial real estate and residential real estate values, could cause an awful lot of value to disappear in a very short period of time. We don't have a real-time way to measure that loss.

Is that an accurate way to——

Mr. REISCHAUER. I think that's a very accurate and real concern, but I wouldn't want to hold out the hope of resolving that particular problem simply on the basis that data always lags.

I think what we really need is to have people, groups like CBO and academics, try and do statistical estimates of the way balance sheets deteriorate with changing economic conditions, so that we can have some faith in gross adjustments as providing some kind of sensitive analysis.

We won't have a completely accurate way of measuring this deterioration, but we could have some sense that if three or four regions have 10 percent declines in real estate prices and unemployment rises by X-percentage points, the likely effect would be a deterioration in the fund of X-billion dollars.

The CHAIRMAN. Well, that's all well and good, but we thought we had built in a margin of safety. We tried to establish a minimum margin of safety to give us a cushion against precisely those kinds of changes.

But, as we know, we've penetrated that margin of safety. That margin of safety isn't all that large, and now, has been cut about in half. As you anticipate, it's going to be shaved down further here. If you get one or two big banks going down or two medium-size banks going down, you could exhaust the remainder of that cushion.

So, it seems to me already we've taken ourselves into the danger zone in terms of this margin of safety. When we see a build-up of new adverse economic conditions are and you've already used up half your margin of safety or more, you get to a point where the fund balance may be in jeopardy. It's not inconceivable that, within a 6 month period, you could have an accounting surplus left in the fund based on old data, but immediately after a field audit, you find yourself under water, with claims that exceed what's left in your fund.

That's my concern at this point. I don't think that we have yet taken the steps to assure ourselves that that's not the case.

I'd like your comment on that.

Mr. REISCHAUER. I think you're entirely correct. The margin of safety that the fund will have by 1993, according to CBO's estimates, will be only 1-third of what the band had in the 1960's.

Now, FIRREA called for an increase in the ratio of fund balances to insure deposits up to the 1.25 percent level. But, as you noted, GAO has testified and my prepared statement says as well, there is little chance that that level can be reached before 1995, even under relatively optimistic sets of projections about the activity in the Bank Insurance Fund.

Further action to increase that margin of safety is in order.

The CHAIRMAN. I don't know that we have experienced in a number of years the kind of real estate deflation that is going on at the present time. It's accentuated by the the real estate assets—clustered in certain parts of the country—at the RTC, a residual problem of the savings and loan industry.

It seems to me that somehow or another, we're going to have to find a way to capture this real estate problem by measuring the erosion in the listed values, the posted values, which are being used to meet capital standards and whether people are solvent or insolvent. I don't think we have the answer to that right now.

We have events in the driver's seat. That leaves me with a very uncomfortable feeling. This committee is acutely sensitive, every member of the committee is acutely sensitive to the fact that we don't want to be behind events. We want to look ahead far enough to get in front of events.

The whole pattern of hearings and inquiries we have had going on this year, has been to do that, especially with respect to the bank situation.

I want to ask just one other thing. Can you tell us what your latest projections on the Federal budget deficit, figure is, what it would mean if the Bank Insurance Fund were depleted?

But what are your most up-to-date projections on the Federal budget deficit?

Mr. REISCHAUER. The latest budget deficit figures that CBO released were done for the summit negotiators in late June. These figures showed a budget deficit estimate for 1991 of $232 billion, assuming that the RTC was given authority to extend its activities and not be constrained by the current limits.

Clearly, the economy has weakened considerably since then. The price of oil has risen. CBO hasn't completed a new forecast or a new set of budget numbers because the summit negotiators do not want all the pieces of the puzzle moving at once. But a back-of-the-envelope calculation might lead one to expect that the deficit would be $30 to $35 billion higher than the $232 billion that CBO estimated in June.

This estimate, of course, assumes that no changes in policy nor substantial deficit reduction measures are enacted.

If there were a serious deterioration of Bank Insurance Fund over and above what CBO's baseline includes, it would have to be added on.

The CHAIRMAN. Well, that's a very sobering number.

That would create a sobering increase in the deficit projection in just this short period of time because of these new events. Those same economic factors are at work in the economy as a whole, and they're therefore working against the balance sheets of companies and banks.

I mean, these things don't stop at a wall. They're pervasive throughout the economy.

So let me not take more time at this point. Senator Garn.

Senator GARN. Thank you, Mr. Chairman.

I would only comment that those remarks about the budget deficit are much more than sobering; they are frightening, because I look at it from the perspective of when I was a new freshman Senator in January 1975. I listened to Gerald Ford's State of the Union message. The next day, he sent up his budget request. And his budget request was for $295 billion to run the whole country.

Just 16 years later, we're talking about a $265 billion deficit.

This Senator has a little bit of a hard time comprehending that—in a period of 16 years—that much of an explosion of spending.

In your statement, you note that the Bank Insurance Fund only incurs losses if institutions are closed after the real value of their assets is less than their liabilities.

Obviously, one way to increase the probability that regulators will be able to close institutions before their net worth is totally depleted would be to raise capital requirements.

One of the problems with that, obviously, is the dividend banks are able to pay to their shareholders either are reduced by increased deposit insurance premiums or by increased capital.

If you were given a choice between raising deposit insurance premiums and raising capital, do you have a preference between those? And if so, why?

Mr. REISCHAUER. Offhand, I don't have a preference. I think that this is the kind of judgment that should be left in the hands of the Congress.

Senator GARN. Well, I was hoping that you——

Mr. REISCHAUER. CBO was designed to provide the Congress with options, not recommendations.

Senator GARN. Well, you could have said both. [Laughter.]

Mr. REISCHAUER. That would have been equally unhelpful.

Senator GARN. Obviously, higher deposit insurance premiums raise the cost of doing business for banks, at some point, you reach a point of diminishing returns where you're not helping the fund. Going to such high premiums that you put banks in jeopardy, causes more failures.

Yesterday, the Comptroller General indicated that 1.25 percent was not sufficient, but he didn't know where that breaking point was.

Do you have any opinion on how high premiums might go and what that reserve should be before we start being counterproductive and cause more of a problem for the fund than we solve?

Mr. REISCHAUER. The real issue here is how fast you raise the assessments because, as you noted, raising them has the prospect for reducing the profitability of banks. If banks' profitability is already shaky because of past investment decisions and the current state of the economy, you clearly don't want to raise assessments too fast.

The level that you should shoot for is really a value judgment. FIRREA laid out 1.25 percent. That's below the average level since the establishment of the FDIC up through the end of the 1960's, despite the fact that there may be more volatility in the economy now than there was in much of the post-war period up to the beginning of the 1980's.

The United States is more interdependent with the rest of the world, more dependent on certain commodities traded in the world, whose prices have gyrated drastically in very short periods of time for both political and economic reasons.

So, given that historical record, it may be prudent to shoot for a higher level than was attained in the 1970's, for example.

Senator GARN. See, the difficulty is—and don't misunderstand—I appreciate the work you do and the recommendations you make, the same with Mr. Bowsher yesterday.

But it's easy to come in and say, the fund is being depleted. We already know that. It isn't too hard to figure out. It's easy to say, it ought to be higher than 1.25 percent, but I don't know exactly how high it should be. It's easy to say, we need to charge more premiums because the fund is going down.

The dilemma we're faced with is that most of the banks in this country are in good shape. We concentrate on the negative. That's even true of the S&L industry—the poor guilt-by-association syndrome. There are a lot of S&L's out there that are doing exactly what they were supposed to be doing, very well run, conservatively run, making a profit, and not causing the fund or anybody else any trouble.

That certainly is true in the banking industry and particularly with the small independent banks across this country.

And we just can't willy-nilly raise premiums because it's the perception that we should, and place in jeopardy a lot of these institutions, particularly smaller ones, that are well run, not on anybody's trouble list, but that operate on relatively small profit margins, $80, $90, $100 million banks, community banks. You know the type I'm talking about. We raise those premiums and we cause problems.

So it's a dilemma. And I don't know exactly where they should go. I wish there was somebody that could at least make some recommendations and look into that problem of where can we go so that we can increase the fund, reduce that vulnerability, but at the same time don't cause more problems than we're solving?

FIRREA overall was a good bill. But we narrowed the S&L's franchise while we all beat ourselves on the chest and say, we did something about the S&L crisis, while we're reducing the value of that franchise. Nobody wants to buy them, so we push more on the insurance fund and we create more problems for the regulators because we've devalued the value of that franchise.

I don't want to do that with the banking industry.

Mr. REISCHAUER. I think the option here is to establish a set of rules that would close banks earlier. Then this would reduce the need to raise assessments on those that are healthy, those that are doing a good job, and those that are acting prudently because the probability then that the fund would be stuck with a real loss would be reduced substantially.

So I think you have a choice between those two options.

Senator GARN. Well, we've got lots of choices. There's no doubt about that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

A lot of us are troubled. That's the least I guess we could say. We're deeply troubled by what we've been hearing from you at the table, by what we've uncovered on our own, concerning the condition of the FDIC, or the Bank Insurance Fund, as we call it now, concerning the real situation out there.

I know that the margins are thin, at best, not just from your testimony, but from the Comptroller General and other information that we are privy to.

I believe we have an obligation to the American people to provide a sound working banking system. We have to have it. But we also have that same relationship and responsibility to the American people, the taxpayers, to try to not let them bail this situation out if it keeps going down.

And you can look at the charts and you can see it's on thin ice now. Is it not?

Mr. REISCHAUER. [Nods in the affirmative].

Senator SHELBY. OK.

The **Chairman**. That affirmative nod ought to be oral so that it can go into the record.

Mr. **Reischauer**. Yes.

The **Chairman**. So I take it the answer is yes, Mr. Reischauer?

Mr. **Reischauer**. We're on thin ice, correct.

Senator **Shelby**. Thin ice. Thin ice right now.

Mr. **Reischauer**. But our skates are still dry. [Laughter.]

Senator **Shelby**. OK. Let's consider the importance of a good accounting system when an accountant is performing an audit he is looking for a value or the truth of a given situation, is he not?

Mr. **Reischauer**. [Nods in the affirmative].

Senator **Shelby**. That's why we have accountants. How can you have a good accounting system if you don't mark real estate loans or other things of value to the market when you're doing the audit?

You can't, can you?

Mr. **Reischauer**. Certainly, that's correct. You can't. But it's not an easy thing to do. It's extremely difficult.

Senator **Shelby**. I know it's not easy. But if you buy a bond, a junk bond, a high-yield bond, or say it's an investment-graded bond, the value of that bond changes, doesn't it?

Mr. **Reischauer**. Correct.

Senator **Shelby**. It changes as interest rates move, as a number of factors affect its value, such as the risk out there, the quality of the company, how it's doing and so forth.

But we don't do this as far as the accounting of the portfolio of loans that are held by most of our banks.

Isn't that the basic accounting problem?

Mr. **Reischauer**. That's correct.

Senator **Shelby**. That's correct. OK. Let's consider risk. In the insurance industry, generally, you set a premium in accordance with the amount of the risk associated with the insured.

In other words, if I have had three bypasses and I'm looking for life insurance, I'm sure that they'd probably change me higher rates than they would someone who ran four miles a day, was a little thinner than I was, and had a heartbeat of so and so.

It's based on risk, is it not, private insurance?

Mr. **Reischauer**. It is, but it's also one reason why you buy some insurance through groups, so that risk can be shared across a group.

Senator **Shelby**. Right, so it's spread.

Mr. **Reischauer**. In the Bank Insurance Fund, the Nation's banks have been made one big, "happy" group.

Senator **Shelby**. One big, happy group. But are they happy today, because a lot of smaller banks in the country, in my State of Alabama, probably in the State of Utah, Michigan, Florida, and so forth, with assets of say $100 million, soundly run, or well run, they're saying, goodness, look at this big premium I'm being assessed because of the money center banks, some of them, because they've made a lot of stupid loans and they're at risk and they're liable to take our own fund down.

In other words, the level of premium is the same, isn't it? It's spread out over the group.

Mr. REISCHAUER. Yes, it is. I should note for the record that my reference to the word "happy" was in quotes. [Laughter.]

Senator SHELBY. OK.

Mr. REISCHAUER. I wasn't by any stretch of the imagination suggesting that this was a happy group.

Senator SHELBY. We're looking at this problem as seeing that it's not just going to go away. If we in the Congress, starting here in the Banking Committee, don't face up to the real problem, it's going to be in the taxpayers' lap, at the rate that we're going. Isn't that, with a small downturn in the economy a possibility there?

Mr. REISCHAUER. There is a possibility there, yes.

Senator SHELBY. So what are your recommendations that we do here? We know the problem. We know it's a crisis.

Mr. REISCHAUER. The first thing to do is get hold of good numbers, as CBO has attempted to develop for you to show what the risk is.

Senator SHELBY. Seek the truth.

Mr. REISCHAUER. That is, seek the truth. Then you want to recommend steps if there is a problem. While CBO's numbers, as I suggested earlier, indicate that the fund could squeak through, you might want to ensure your evening's rest by having a greater margin of safety there. Then you want to consider the options available to provide that margin of safety.

As I said, there are a number of them. One is to strengthen the economy. That would go a long way to easing all of these concerns.

Senator SHELBY. Of course.

Mr. REISCHAUER. I don't like to give the impression that CBO has only one answer to every question; but, in fact, we usually do.

Senator SHELBY. A lot of things are predicated on the economy, is it not?

Mr. REISCHAUER. And that answer is to reduce the deficit. That would be the first recommendation that I would make.

Senator SHELBY. OK.

Mr. REISCHAUER. Then consider regulatory steps that would allow closure at an earlier point before the fund was really at risk.

Senator SHELBY. Just stop the hemorrhage, in other words.

Mr. REISCHAUER. Then consider whether the increases in assessments or premiums that are written into FIRREA are maybe too modest. You may not want to increase the pace over the next year or so, but there is a limit of 32.5 cents on that assessment. You might ask is that reasonable, given where the fund needs to go?

Senator SHELBY. How important is—excuse me go ahead.

Mr. REISCHAUER. Then, as I mentioned in my testimony, a good case can be made for giving the FDIC greater borrowing authority. While the fund might squeak by, on average, over a period of 5 or 10 years, nobody can really predict the year-by-year pattern of losses that will occur because of the cycles in the economy. It's not clear that one would want to set premium rates, or whatever, so that they could adjust for radical shifts up or down or the failure of one large bank or two large banks. These are episodic events that might occur once in a decade.

So what you want is for the fund to have sufficient borrowing authority to handle episodic events without having to restructure or come back to the Congress.

Senator **Shelby**. What about the capital ratio? Isn't that the first thing that we ought to be considering? You know, if a bank is well capitalized, they're going to be paying off bad loans out of their money before they ever hit the Federal Insurance Fund.

Shouldn't that be the number one thing for a banking system, an asset-to-equity ratio should be increased?

Mr. **Reischauer**. Well, we have done that somewhat through FIRREA, and there is a question of whether——

Senator **Shelby**. We can reach that.

Mr. **Reischauer**. Whether we can reach that, No. 1.

Senator **Shelby**. Right.

Mr. **Reischauer**. No. 2, whether we take disciplinary actions when banks fall below those ratios and take those actions quickly.

Senator **Shelby**. But if we don't take those actions, we're waiting for a disaster, aren't we?

Mr. **Reischauer**. For a disaster to happen.

Senator **Shelby**. And if you don't close something down, before it's about gone, you're going to pay a bigger price later. That's what you were alluding to.

Mr. **Reischauer**. Correct.

Senator **Shelby**. My time's expired.

The **Chairman**. Very good. Senator Pressler.

Senator **Pressler**. Thank you very much, Mr. Chairman. I think this follows up some of the concepts expressed by Senator Shelby and others here about how sound banks are required to share a disproportionate amount of the risk.

Now, in my home State of South Dakota, I am told the commercial banks, most of which are community banks, have an average primary capital ratio of 8.23 percent. Many have ratios higher than 15 percent. Nationwide, the average primary capital ratio is about 6 percent, I believe.

This leads me to ask your views on risk-based capital assessment, rather than the arbitrary rate that has always been used. I know that Treasury is to report on this, but I would appreciate hearing your views. You've expressed some of them already.

Do you believe that a system could be devised that would work properly and fairly?

Mr. **Reischauer**. One can certainly be designed. I'm not in a position right now to say that I would recommend or not recommend that particular step. It's something that we have begun to look into, but haven't completed our work on.

Senator **Pressler**. OK. When will that be out, or when will that report from the Treasury be ready?

Does anybody know?

Mr. **Reischauer**. CBO is in the process of preparing a study for the House Banking Committee, which will deal with these issues and react to the reports that other agencies are putting out.

Senator **Pressler**. Very good. We will look forward to that. Thank you, Mr. Chairman.

The **Chairman**. Very good, Senator Pressler.

Senator Graham.

Senator **Graham**. Thank you, Mr. Chairman.

As I indicated in my opening statement, I'm very concerned about the sense of urgency of getting on with this issue and particularly what should be the agenda of action from now until the end of this session of Congress.

In yesterday's discussion with Mr. Bowsher of GAO, a number of possible immediate steps were recommended. I'd like to briefly review those as I have them in my notes for your comments as to whether they would be on your list or whether they are items that are not on this list that you would add.

One was to request the Treasury to accelerate its current study of deposit insurance, which is presently planned to be available at the end of this year, to have it available for immediate consideration.

Two was to add various controls, including some internal accounting controls which the GAO had recommended, but which were not included in the final FIRREA bill of 1989.

Third, to strengthen data collection systems.

Fourth, closer relations between the regulators and the accounting profession, including writing to the accounting standards board relative to some concerns as to generally accepted accounting procedures that are obscuring the reality of conditions of banks.

Next, assure an adequate number and quality of staff in the regulatory agencies.

Next, to increase the maximum insurance premium. FDIC has just used its administrative authority to come to the maximum which is currently allowed under law.

And finally, to consider replenishment of the FDIC to give it a sufficient working capital fund.

I was struck by the statement that you had on page 18 which talked about increasing FDIC's borrowing authority so that it could respond rapidly to a large bank failure or to a large number of smaller bank failures over a short-term period.

This would prevent a short-run cash shortage from delaying case resolutions, a practice that added substantially to the cost of the S&L bail-out.

I believe it was to that point that the last recommendation was made.

I'd be interested in your comment on that agenda of action.

Mr. REISCHAUER. OK. Let me start with the bottom of the list and work up. You premised your question by asking which of these measures would make sense for congressional action this session.

Having spent the last 5 days out at Andrews Air Force Base with the summit negotiators, cannot be anything but overwhelmed at the amount of legislative action that will come out of that set of negotiations and will clog the congressional system and divert your attention away from what I think should be a very careful and measured reform and revision of the Bank Insurance Fund situation.

Senator GRAHAM. If I could, to that point, yesterday's discussion and certainly my intention is to draw a line between what I would consider to be fundamental reform and sort of emergency actions. I'm trying to develop that latter list of emergency actions, recognizing that there are many other things to be done, but the system will not be placed in further jeopardy if we wait until 1991.

Mr. REISCHAUER. Starting at the bottom of the list then, the issue of providing the FDIC with increased borrowing authority or an ability to generate working capital is a short-run but important measure that would make a good deal of sense for the Congress to consider this session.

Increasing the maximum premium is another. As you noted, the FDIC is already increasing it to 19.5 cents. The concerns that the chairman and Senator Garn expressed about the economy's impact on bank profitability suggest being careful on that score simply because, in the short run, you don't want to make the situation worse. You don't want to push some weak banks, which are otherwise of recovering, over the brink.

The number and capability of the staff is an important issue when faced with decisions on the 1991 budget and the way deficit reduction pans out. The last decade showed quite clearly that when one seeks budgetary savings by reducing the staff capability of certain regulatory agencies, you end up costing more money in the long run than you saved through the short-term reduction in personnel costs.

With respect to accounting standards obscuring the true situation, these are very complex issues and should be on the agenda for the next Congress because the development of new information about what is possible and the implementation problems that may result should cause some debate.

Strengthen the data collection system, certainly. My comments on this would parallel in many ways those that I gave with respect to the staff.

Without accurate and timely data, you don't know how bad the problem is and you can't design solutions.

I'm in no position to know whether the Treasury could accelerate its study. They're probably close to having drafts that could inform the deliberations of this committee which they might be willing to share with you.

The final issue dealt with——

Senator **Graham**. The question of the controls that have been recommended by the GAO that were considered but not included in the FIRREA.

Mr. **Reischauer**. Yes, right. I'm not familiar with the detail of those and certainly would expect GAO to have a more informed judgment on those matters than would the Congressional Budget Office.

Senator **Graham**. Mr. Chairman, my time has expired. I have some other questions, but I'll take them on the next round.

The **Chairman**. All right. I might say, too, that we've got two other witnesses this morning that we will want to hear from after Mr. Reischauer.

Senator Dodd.

Senator **Dodd**. Thank you very much, Mr. Chairman.

Let me apologize to you and the witnesses. We had a lengthy mark-up this morning in the Labor Committee on the National Endowment for the Arts and Humanities. That's a rather intense debate. It went on for several hours. So I apologize in not getting up here to hear your opening statements and the questions of my colleagues. I gather from staff that the ones that I'm about to address to you here have not been raised or, if they have, in one particular case, only on the periphery a bit.

Mr. Chairman, let me commend you as well for your comments yesterday in the wake of—or during yesterday's hearing. I couldn't agree with you more about the necessity to move quickly on dealing with the fund. It's vitally important that we not, with the few weeks remaining around here, waste the opportunity.

It would be, in my view, February or March before we get back to that issue, unless there is a lame duck, and I'm not convinced there's going to be a lame duck session around here, allowing that much time to go by without addressing that question.

It seems to me, we may be called back to deal with it, just that question. People assume there may be something else. But that could be the issue that draws us back.

So I commend you for your call for early action in that area.

Mr. Reischauer, I wonder if you might—I gather you talked about early intervention in your opening remarks or in response to some of the questions. We've been told over and over again, of course, that we could better protect these deposit insurance funds if we had forced or required the regulators to move quickly to take corrective action against those institutions and to close several severely troubled banks and thrifts before they became insolvent.

In your opinion, would the cost of resolving these thrifts, as well as the BIF, be in better condition now had we in fact required that kind of action?

Mr. REISCHAUER. I think the answer is clearly yes.

Senator DODD. Would you recommend annual examinations, for instance, of every institution to determine their solvency, on-site examinations? Or is that too much?

Mr. REISCHAUER. There is some difficulty, of course, with requiring examinations annually for all institutions. It's a burden on the institutions. It's a costly exercise. The idea of implementing early closure rules is a way to compensate for the fact that the existing accounting system may not accurately reflect the current status or condition of the bank.

So a trade-off exists between how rapidly you want to keep running banks through reassessments versus how far up you want to go on the closure rules.

Senator DODD. I can see that being a problem at the outset. I mean, as you initiate——

Mr. REISCHAUER. What you want to do is monitor the ones that appear to be in trouble, the shaky ones, more closely, more frequently, and with more diligence.

Senator DODD. I appreciate that. I understand that, the notion of on-site examinations on an annual basis of every institution.

My own personal reaction is that seems a rather heavy burden to bear. But as I thought about it, it occurred to me that that's true certainly in the first year, maybe in the second year. But as you begin to develop the ability to conduct those kinds of examinations, it would seem to me that in the ensuing years, it would become less difficult and less onerous once you establish the practice, so to speak. Not that you're doing less of an examination in the ensuing years, but the fact that you've familiarized yourself with the institution and the likelihood that there are going to be dramatic changes from one year to the next. That's not necessarily the case.

I mean, am I simplifying the matter too much by that point?

Mr. **Reischauer**. I think that statement is correct. It would certainly be easier on the institution and easier on the Federal regulators, the more frequently exercise is done. But this still takes a lot of resources to do.

Senator **Dodd**. Did you interpret the GAO's recommendation for on-site examinations, the emphasis on on-site examinations being more of the not every institution every year, but just more on-site examinations generally, without getting into the specifics of an annual visit to each institution?

Mr. **Reischauer**. I've read the testimony and that was my judgment from the testimony. I haven't read their full report.

Senator **Dodd**. OK. Some have argued, switching a bit here, the questioning, some have argued that the banks—we're seeing as many failures as we have because there's consolidation going on within the industry and that the process of consolidation is almost over.

In your view, are bank failures a problem—some are suggesting they were a phenomenon of the 1980's, and that now that the consolidation is ending, that the problem is now coming to an end now that we're entering the 1990's.

What is your response to that observation?

Mr. **Reischauer**. I've been told that a number of analysts believe that the phase of consolidation is not over and, in fact, that considerable consolidation could take place in the next 5 to 10 years, shrinking the number of institutions possibly by 40 percent.

Senator **Dodd**. By how much? I'm sorry.

Mr. **Reischauer**. From 13,000 maybe down to 7,000 or 8,000. There's a range, clearly. But the indication is that consolidation wasn't a phenomenon of the 1980's alone consolidation might have some more fundamental causes behind it that relate to changes in our economy, changes in our integration with the world, and changes in regulation.

There may be a lot more consolidation in the future as well. So we shouldn't hold out that as a hope, as a salvation.

Senator **Dodd**. Congressman Schumer of the House and I have introduced a full interstate banking bill.

What is your reaction? I presume you haven't sat down and examined thoroughly the Schumer-Dodd or Dodd-Schumer bill. But just on the general proposition, what's your reaction to it?

Mr. **Reischauer**. I think we would probably be safe to answer that question for the record.

[Response to Senator Dodd's question follows:]

The Congressional Budget Office has not done a study of the specific bill to which you refer. However, interstate banking can be discussed in general. Removing restrictions on interstate banking, which would come through repealing or amending the McFadden Act of 1927, would be one possible way of making the depository institutions industry more efficient. As interstate banking relates to deposit insurance, its chief advantage is that it permits depositories to diversify their risk geographically. This diversification should reduce the average level of risk of individual institutions, and thus reduce the risk of the Federal deposit insurer.

There is a drawback, however, to moving to this higher degree of efficiency—inefficient depositories, including those that follow poor strategies of geographic expansion, will leave the industry and, if they are not absorbed by healthy depositories, will be resolved by the Federal deposit insurer at a cost to the insurance fund. In these cases, this strategy of introducing a regulatory reform measure, which will lead to greater efficiency in the depository institutions industry in the long run,

> may have serious consequences in the short run to an insurance fund that is already under considerable financial stress. It might be preferable to ensure that the deposit insurance fund is sufficiently sound before introducing reform measures that have the possibility of substantial short-term costs—even if the proposal has certain long-term benefits—or to establish some other mechanism to absorb short-term adjustment costs without further jeopardizing the Bank Insurance Fund.

Senator DODD. You know Schumer well, huh? I wasn't asking on the bill itself, just the concept of full interstate banking. I'm not asking you to comment on the legislation, but as a proposition, the notion that has been called for by a number of people—the Chairman of the Fed, Mr. Breeden at the SEC, Mr. Clark at OCC. There are a number of people. I think virtually every person we've had up here, at least from the administration to date, has, when we've raised the question about full interstate banking, endorsed it as a concept, without getting into the particulars of an individual bill.

Mr. REISCHAUER. An important question is whether full interstate banking would lead to diversified risk and, therefore, make the system safer.

There are people on both sides of the issue, which has been one of the arguments in favor of interstate banking, but some have raised questions on whether this, in practice would lead to a diversification of risk.

Finding the answer to that fundamental question should affect whether one views full interstate banking as a step in the right direction.

Senator DODD. All right. I appreciate that. I would appreciate as well, if it's not a burden, but if you could provide just a brief comment on the bill that Congressman Schumer and I have introduced.

I don't want you to go into great detail. I don't want to tie up staff time doing that. But I would be interested in your reaction to it.

Mr. REISCHAUER. Yes. We'll be glad to provide that for you.

Senator DODD. Mr. Chairman, thank you.

The CHAIRMAN. Mr. Reischauer, I want to just raise one other item and then maybe the other members that want to do so, can do so also briefly, and then we can go to other witnesses.

But in this morning's Wall Street Journal, there is a story that you may not have had the chance to see. I'll just read you the headline.

It says, "Chase Manhattan Forced to Sharply Boost Yield on 200 Million Subordinated Notes to 13.01 Percent." I'm going to read you just a few paragraphs from this. And this isn't to put the knock on Chase Manhattan. This is today's news and it's relevant to our discussion.

It says as follows, and I bring this to the attention of my colleagues, too:

> Chase Manhattan Corp., the parent of Chase Manhattan Bank, was forced to reset the rate on 200 million of auction-rate subordinated notes to yield 13.017 percent, up from the previous rate of 9.66 percent. The new yield was 4.92 percentage points higher than the yield on 2-year Treasury notes and just shy of the maximum permissible spread of 5 percentage points above 2-year Treasuries.

I'm going to continue on here for a couple more paragraphs.

> * * * "Most people were pretty shocked by the rates," said one corporate bond trader who had expected the notes to be reset at a spread of between 2½ to 3 percentage points above the 2-year Treasury note. When the Chase notes were last

> reset in 1988, they were priced to yield 1.05 percentage points more than the 2-year Treasury notes to show this enormous difference in spread change over that time.
>
> But times have clearly changed for the banking industry. Spreads between yields on Treasuries and other securities issued by financial corporations have been widening for months as concerns about rising loan losses and fears of an economic recession prompted credit-rating agencies to downgrade banking securities. That, in turn, prompted investors to dump the securities, sending prices spiralling lower.
>
> Chase Manhattan has a credit rating that is on the borderline of investment grade. If the bank's debt is downgraded another notch, it would be rated on the same level as a top-tier junk bond.

So says the Wall Street Journal.

Now, there's a further commentary on why people think that this might be serious.

My point in raising it is that, when the markets talk to us, we have to pay attention to them. And markets are sophisticated and, yes, there may be a psychological element at play on any given day. But the private market is betting its own capital very carefully.

Doesn't this tell us, Mr. Reischauer, that the market making a very careful value judgment, showing a great deal of apprehension and a great deal of uneasiness when it demands these kinds of rate premiums that have widen out so fast over a relatively short period of time?

Doesn't that tell us that unless the market's wrong, something's going on here, something the market feels it has to discount?

Mr. REISCHAUER. It clearly does. There is also a question of to what extent is the market's message attributable to events over which Chase or any single bank has or doesn't have control. Let's say that all of this was attributable to the very rapid rise in oil prices. This has put the economies of many developing nations in trouble regarding their ability to service their debt that Chase might hold.

The CHAIRMAN. Right.

Mr. REISCHAUER. I'm just making this up—say this situation has deteriorated substantially, so that what looked like a shaky but acceptable investment 2 months ago suddenly looks relatively worthless.

If that's the situation and that's what's going to lead to increased draws on the Bank Insurance Fund, is that a burden which the general taxpayer appropriately bears as opposed to the banks?

This open issue remains as to whether the Bank Insurance Fund should be totally finance-supported by banks or whether the country as a whole should chip in when catastrophic events occur that are beyond the reasonable foresight of prudent private sector individuals.

An analysis of that sort can instruct you on which corrective steps are appropriate.

The CHAIRMAN. Isn't it fair to say that we're getting an warning light from you today in your testimony. We got one yesterday from Bowsher.

Aren't we getting an alarm signal from the market with stories like this?

Mr. REISCHAUER. Certainly, you are.

The CHAIRMAN. It's very difficult to analyze and to understand in any perfect way what's taking place. But you take a reading. You try to get careful professional assessments. You've given us one today. The Comptroller General gave us one yesterday.

This is a single bank but, nevertheless, it's a significant one, a major bank. The financial markets are expressing a very important value judgment that's now there for us to understand and make sense out of.

This adds weight to the notion that there is an underlying erosion occurring, some of it relating to the sharp increase in oil prices that affects Third World debt. That is all the more reason why we'd better understand how quickly we could burn through the rest of the fund.

We're not working with market values. We're working with accounting assessments that are months old. They're not relevant in many cases.

Residential real estate values in this area are thought to be dropping about 1 percent a month, and have been for sometime.

It doesn't take very many months of that before you can burn through even the deposit, the downpayment that someone has made. The same way with a commercial building. I keep reading about all of restructurings by big real estate moguls in this area and Donald Trump and all the others.

We have drawn down this Bank Insurance Fund until it's really paper thin, if in fact it's there at all.

And it seems to me that we're not operating in a prudent fashion. We've gone beyond the bounds and the market is telling us that.

The market is saying, wait a minute, we don't like the feel of this. If you want us to put our money on the table, then we want 13.017 percent to take the subordinated debentures of Chase Manhattan Bank.

I think that's a pretty powerful message. What would be your response to that?

Mr. REISCHAUER. I agree with you wholeheartedly. I think it is a powerful message if it is sustained, as you said in your comment.

The CHAIRMAN. Well, I hope it isn't sustained.

Mr. REISCHAUER. So do I.

The CHAIRMAN. I mean, if that's sustained, then we're going to have an awful lot to do in a hurry here.

Senator Shelby, do you have any additional things? Or Senator Graham? Senator Dodd.

Senator SHELBY. I don't. Thank you, Mr. Chairman.

Senator DODD. No.

Senator SHELBY. I do appreciate his candid testimony here.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Mr. Chairman, in deference to the next panel, I would like to ask a question and request a subsequent response.

And that is, you indicate at the end of your paper the importance of Congress having sufficient information upon which to make appropriate judgments, and that the lack of reliable information contributed to the huge cost of the savings and loan bail-out.

I would like your recommendations of what data should we as the Congress be requesting and any thoughts as to how we could most effectively utilize that information to place us in a position to be appropriate independent evaluators and decision-makers?

Mr. **Reischauer**. In response to that, CBO has been trying to help evaluate the situation with your committee staff and to provide useful information that the committee staff would like.

CBO would need to know who exactly is on the FDIC's problem list. We would need to know the CAMEL ratings of the banks. We would need to know the banks that the FDIC intends to resolve over the course of the next year. We would also need to know how the FDIC's estimated losses compare with actual losses. Currently, there is no way to compare the track record with what's going on.

Those four things would go a long way to improving CBO's ability to analyze this problem and I think the ability of your staff as well.

Senator **Graham**. Thank you.

The **Chairman**. Please give us anything else for the record that you have that responds to that question.

I want to thank you for your testimony today. It's been very helpful to us, and I, too, want to underscore the point others have made, and that is we appreciate your directness and candor. It's very important to us.

Let me now call to the witness table Mr. Michael DeStefano, who is the vice president of Standard and Poor's Corp. At the same time, let me also call up Mr. Robert Eisenbeis, who is the professor of banking from the University of North Carolina at Chapel Hill.

We'll wait just a minute for the room to quiet down before we start.

Let me just say before we hear from these two witnesses, I consider you both very distinguished expert witnesses and we appreciate your being here this morning and your patience in sitting through this first panel. I know you will have some thoughts and reflections on points that were raised and I'd like you to feel free to digress to make those points in addition to your written testimony.

We'll make your written testimony a part of the record and I'd like to go right to your summary comments.

Mr. DeStefano, we'll start with you and we'd like to hear from you at this time.

STATEMENT OF MICHAEL DeSTEFANO, VICE PRESIDENT, STANDARD AND POOR'S CORP., NEW YORK, NY

Mr. **DeStefano**. OK. I appreciate the opportunity to be here and we did submit some written statements. In the interest of expeditiousness, I'll make a very brief summary of the testimony that we submitted.

I might say that what S&P does is rate a portion of the universe of banks, a rather small portion as measured in numbers. We have ratings on 130 bank holding companies, which probably own something like 200, 250 banks, as compared to the 12,000 banks that exist in the country today.

However, those 130 bank holding companies account for about 60 percent of the industry's assets.

We recently had occasion to publish credit reviews of 30 of the largest bank holding companies which account for approximately 40 percent of the industry's assets. So while in terms of numbers, it's a small universe, in terms of assets under management, it's a large part of the industry.

We've had occasion to——

The **Chairman**. Excuse me. Can I have you pull your mike a little closer? I want the folks in the back who are behind you to be able to hear you.

Mr. **DeStefano**. OK. We've had occasion to do a significant number of downgrades recently; actually an unprecedented number of downgrades have come rather rapidly. However, I'd like to point out that those downgrades are really part of a declining trend that we've seen in bank holding company credit ratings since really about 1980.

When S&P first began to rate bank holding companies in the mid-1970's, most bank holding companies had ratings of AAA or, at worst, AA. Since then, reflecting the troubles of the decade of the 1980's, which include everything from LDC to real estate problems to energy and lending, ratings have come down. And while our universe still is an investment-grade universe, by and large, with an average rating of about A, that's still a significant move down from the AAA standards that we had in the late 1970's.

Our reading of the situation currently is that there is a lot of, there's a sizable number of problems still on the plate of the industry. LDC is of concern. A small number of banks, but some of the larger ones, still have some unreserved exposure.

Real estate is a problem, for the regional banks, especially, but also, to some extent, for the money center institutions. And HLT is a potential problem for, especially, the money centers.

So there's a lot to be concerned about in terms of asset quality.

In our view, the declining trends of the decade of the 1980's probably can be accounted for. By big picture, the increased competition which the U.S. banking industry has been laboring under. And that competition has come from two principal sources—one, the capital markets. While prior to the 1970's, prime credits went to banks to borrow, they no longer have to. They go directly to the capital markets. That's meant that the old relationship business that used to really sustain banking is pretty much gone because the good credits go directly to the market.

And then the other competitive factor which is relatively new is foreign bank lending, which has had tremendous penetration in the commercial and industrial areas of lending. Something like 25 percent of C&I assets are held by foreign banks. And these tend to be the better quality assets.

Foreign banks are willing to compete on price, and to go after good quality business, as a result of which, many U.S. banks have had to seek earnings opportunities elsewhere; notably, in areas which I think we would all recognize as being high-risk areas—commercial real estate lending, lending to HLT's, and even, in fact, in the early 1980's, lending to LDC.

The **Chairman**. Are domestic banks losing out to foreign banks in those high-quality industrial and business customers because of price competition, principally?

Mr. **DeStefano**. I think it's, pure and simple, price competition. Foreign banks who are active in this country are willing to go after prime credit at very, very low spreads. Most U.S. banks find that business virtually unprofitable. And I think there are other issues here—cost of capital, cost of funds to foreign institutions, which is a whole other subject.

The CHAIRMAN. Yes. When the foreign competition comes in, they will underprice to pick up market share and drive out domestic players and then, of course, rates climb back up or the prices for the products climb back up.

Any sense that that's happening?

Mr. DESTEFANO. That's a good observation and it's very possible that that will happen, especially if problems develop in some of the home economies of the foreign banks. We may see, one, retrenchment in the kind of pricing that they're willing to offer. And two, maybe just some cutbacks in their efforts in the U.S. market as their own cost of funds and cost of capital go up.

This is not the place to comment upon ratings trends elsewhere, but I might just say as an aside that Japanese banks have been experiencing some problems of themselves. The ratings actions there, at least in terms of our outlook, have become more pessimistic there.

Also, given the rise of interest rates in Japan, one has to assume that their cost of funds is going to be going up.

So it is possible that, going forward, we may see less competition on the domestic front than we've seen in recent years. But I really think it's too early to reach any conclusion.

The competition from the capital markets may also abate slightly in the sense that lesser quality credits which really benefited from the junk bond boom, which historically were bank customers, went to the markets directly. Given the conditions in the junk bond market, it seems unlikely that they'll be able to do financing there, and they may return to the banks.

So it's possible that some of the competition for the lesser quality credits will abate. The competition for the best quality, I don't think that that's ever going to go back to the banks. There's no reason for Exxon to borrow any more from the banks because it gets cheaper funds in the capital markets.

Commercial paper used to be a very small market. It's grown. Nonfinancial commercial paper is something like $300 billion now, daily outstandings. That used to be at one time bank business and it no longer is.

I just wanted to, as I say, summarize the trends that we've seen. We think that there is a substantial amount of problems. I would, however, reiterate that in terms of the larger institutions that we do see, we would still see considerable amount of strength there, of credit strength.

I would make the observation that it's in some ways tough for a money center institution to fail, the liquidity issue aside. They do have capital and reserves, diversified business lines, many sources of revenue. And the experience of the 1980's has been that the largest, best known institutions that have access to capital have been able to come back from very difficult circumstances and survive.

And I would note the BankAmerica case and the Mellon Bank case as two prime examples of that.

Regional banks, on the other hand——

The **Chairman**. Before you go on, react, then, to this [indicating Wall Street Journal article].

Mr. **DeStefano**. I think that this is an illustration of a very, very negative tone in the market for bank holding company paper.

I might just differentiate a little bit here between a bank credit and a bank holding company credit.

The **Chairman**. Right.

Mr. **DeStefano**. We rate both. We would see the bank credits, as would, I think, the world in general see bank credits as being somewhat higher quality than bank holding companies. And then subordinated debt at bank holding companies would be looked at as a somewhat more risky instrument.

The other thing I would point out about the condition of the securities markets for bank paper is that it's a very illiquid market. There are not that many investors in bank holding company paper. There are a lot of reasons for that.

One is that when a bank holding company fails, there's no recoverable value. If the bank holding company fails, your recovery value is really zero.

In the case of an industrial, if you buy an industrial credit, even a single B, you can do an analysis that would suggest that you may recover 40 cents on the dollar, so there's a downside to your loss.

In bank holding company paper, when the banks are taken from the holding company, there's usually nothing left. So the investor is facing really no recoverability, and that's put into the pricing.

And there's a whole sector of institutional investors who won't buy bank holding company paper for that reason. Bank holding company paper tends to be heavily bought by a small number of institutional investors, most notably, insurance companies. And when they move away from the market, which they've done, you can see rather dramatic and adverse pricing impacts because of the illiquid nature of the market.

That having been said, I would agree that the message that we're getting from the capital markets vis-a-vis bank holding company paper is one that everyone ought to be concerned about. And I think it's one that's also been reflected in the rating trends that we've seen over the past decade.

The **Chairman**. Now, if I may just interject again for a minute, and I want Senator Graham to feel free to do the same. One of the strategies that we're looking at as a way to strengthen the banking system and resolve the problem of losing prime industrial customers to commercial paper and foreign lenders is to move in the direction of a financial holding company that would be a multifaceted financial conglomerate of which traditional banking would be only one part.

You would set up a bank holding company with different lines of business and firewalls to prevent self-dealing.

But it seems to me that the general model, as a way to maybe solve the problem of anemic profitability, insufficient capital and retained earnings and capital attractiveness, is go to that model.

I hear that you are saying that you are finding that model, the bank holding company model isn't all that attractive.

Maybe if we changed the configuration, you could find it attractive. But I wonder whether that's really the pot of gold at the end of the rainbow after what you're just said.

Mr. DeStefano. The approach that we take toward holding companies in regulated industries is as follows: normally speaking, a holding company's value should reflect the value of what it holds. So if it holds A banks, you would expect it to be A-rated.

The reason for a differentiation where a differentiation is made is due to the potential regulatory intervention which would stop the flow of dividends up to the holding company.

A holding company will issue debt. It then has to service that based upon the upstreaming of dividends from its operating banks.

The Chairman. Right.

Mr. DeStefano. The regulators control those flows. There are certain rules as to how much you can put up. And the concern in the deteriorating situation is that the regulators will move and prevent that flow up.

The Chairman. Right.

Mr. DeStefano. That's why I think we in the markets generally would look at holding companies in regulated industries as being a somewhat lesser credit than the operating banks that they own.

In terms of a multidiversified holding company, in terms of the credit implications of that, we would really have to see what the creature looks like.

The Chairman. I understand. Right.

Mr. DeStefano. And it would really be hypothetical to comment in terms of what the credit of something might look like.

But I think in regulated industries, the markets and the agencies tend to differentiate at the expense of the holding company in favor of the bank.

The Chairman. Why don't you go ahead? You've answered my question.

Mr. DeStefano. I think in terms of the remarks that I wanted to make, I basically made them.

The Chairman. Very good. All right. Let's stop at that point.

Mr. Eisenbeis, let's hear from you now.

[The complete prepared statement of Michael DeStefano follows:]

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Statement of Michael DeStefano, CFA
to the Senate Banking Committee
September 12, 1990

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Mr. Chairman and Members of the Committee, my name is Michael DeStefano and I am a Vice President in the Debt Rating Group at Standard & Poor's Corporation. I have been at Standard & Poor's for nine years and my primary responsibilities include the analysis of financial institutions, especially commercial banks and thrifts. You have asked us to discuss the condition of the banking industry in the United States. This is very timely since we released a Credit Review on the "Largest U. S. Banks" on July 30. I am happy to be here today to discuss this subject.

Before I begin my discussion of the banking industry, I would like to highlight some key issues with regard to debt ratings. A Standard & Poor's rating expresses our opinion of the credit quality in the form of letter symbols. Detailed rating definitions for both investment grade and non-investment grade long term ratings symbols are attached for your information. The simplicity of the letter symbols and the opinions represented only hint at the resources and effort Standard & Poor's applies to each rating judgement. The value of a rating emanates from the reliability of the professional staff. Standard & Poor's regularly publishes criteria and methodology which show our approach for each industry. In addition, once a rating determination is made public, Standard & Poor's publishes the rating along with a rationale describing major factors which led to our conclusions.

Standard & Poor's currently maintains debt ratings on approximately 130 bank holding companies, some of which own more than one bank. While these ratings cover the largest money center and regional banks in the United States which hold over one-half of the assets of the commercial banking industry, we do not maintain ratings on all banks. Our comments today will focus on those banks which are rated by Standard & Poor's and our knowledge of the commercial banking industry.

In the last six months, Standard & Poor's has lowered ratings on 36 U.S. bank holding companies, some more than once, and upgraded only four. This unprecedented number of downgrades, a result of S&P's ongoing review of the banking industry, reflects asset quality problems that first became manifest in late 1989. Most of the downgrades were driven by deteriorating asset quality in real estate portfolios and concern over loans to highly leveraged transactions (HLT). Several of the rating actions also indicate Standard & Poor's perception of increased risks for holding company creditors, stemming from reduced flexibility that many banks have to upstream dividends to their parent companies. While each rating action was taken in response to company-specific circumstances, the large number of downgrades suggests a systemic problem affecting the banking industry as a whole. In rating terminology, the industry risk of commercial banking has increased, with implications for much of the rated universe of bank holding companies. Bank credit quality has been sliding for several years, although periods of relative stability have cushioned this deterioration. When Standard & Poor's first began rating bank holding company debt in the mid 1970s, most ratings were AAA.

Credit deterioration is most apparent in reduced profitability and in the heightened credit risk in many banks' portfolios. Real estate is the source of most current problems, but exposure to lesser developed countries (LDC) is of lingering concern at a few large banks and the performance of HLT portfolios is likely to deteriorate. Looking back a few years, problems centered in energy related loans, agricultural lending, and loans to the shipping industry.

When a category of loans has run into problems, most lenders with exposure in the area suffered, not just a few reckless ones. Penn Square failed because of energy loans, but so too would have Continental Illinois without regulatory assistance and virtually every major banking company in Texas, the latter with an assist from real estate loans. The recent real estate crash in New England also makes the point. When markets for commercial and residential real estate weakened, most lenders with substantial exposure in the region suffered to a similar degree, as measured by the proportion of risk real estate loans now in nonperforming status.

This suggests that when a category of risk loans deteriorates, the relative degree of exposure distinguishes the final effect on individual banks, as much as how they underwrote specific loans. The systemic nature of credit problems, when they develop, points not just to lax underwriting standards but to a deeper problem: aggressive overlending to growth sectors of the economy and in risk categories of loans. While bankers maintain that they can manage increased asset risk, few deny that recent loan growth has been in riskier asset classes such as real estate, HLT, and unsecured loans to individuals. This trend towards greater asset risk reflects the need to maintain profitability in the face of competitive pressure on margins for lower risk business.

Lending to investment grade, and even non-investment grade, corporate credits is no longer a highly profitable field of business. Many companies now have direct access to the capital markets, and to foreign lenders willing to undercut on price. This competitive environment has contributed to the demise of relationship banking, which had ensured banks a steady stream of corporate business. Instead, banks have had to adjust to a more transaction-oriented approach, with price a key element in winning business.

The evolution towards riskier balance sheets has been accompanied, frequently, by failure to price loans at a level appropriate to their risk. To build their real estate portfolios, for example, banks competed on price, ultimately receiving inadequate compensation for the risks they were assuming. This, in turn, precluded the buildup in reserves necessary to adjust reported earnings for the level of portfolio risk carried by the bank.

The rush into riskier classes of assets has been exacerbated, in some cases, by a failure to offset increased balance sheet risk with higher capital levels. Banking by its very nature is a highly levered business. To maintain their own creditworthiness, banks must either forego asset risk, limiting their investments to the most creditworthy borrowers, or reduce their own leverage. While the current phase-in of new capital standards has been a positive development for the industry's creditworthiness, nominal improvements in capital have not kept pace with the advance in risk assets. By aggregating most loans into the same risk category, regulatory standards do not ensure that capital will increase proportionately with asset risk. On a risk-adjusted basis, capital has failed to keep up with the sharp growth in commercial and construction real estate loans over the last few years.

Many major banks have also suffered from aggressive dividend policies. Banks strained by large exposures to lesser developed countries, for example, have realized off-balance sheet values to counter the drain on capital represented by increasing their reserves. However, many of these banks have not cut their dividends, and in some cases have increased them. Accordingly, while earnings remain strained, payout ratios have skyrocketed, seriously restricting the retention of capital. Barring a striking rebound in earnings, which seems unlikely in the near term, maintenance of current dividends could hinder improved creditworthiness at many banks.

The performance of the U.S. banking industry over the last decade is especially interesting when viewed against a background of generally strong economic growth. Most of the economy expanded for eight years, although certain economic sectors and geographic regions experienced recessionary conditions. The broad-based expansion is not evident in the performance of much of the industry as a whole, but regional and sectorial weaknesses have had evident and striking effects. This suggests that the industry does not benefit from the good to the same extent that it suffers from the bad.

Underlying this phenomenon is the fragmented nature of the financial services industry in the US, which is specialized by both region and product. While other countries have but a handful of major financial institutions, the U.S. has thousands of banks, thrifts, credit unions, insurance companies, finance companies, and investment banks. This fragmentation is the product of history and of a culture that is profoundly suspicious of concentrations of power, especially of financial power. Change is not likely to be easy or come swiftly, if it comes at all.

While a degree of consolidation and enhanced powers to offer new products have occurred in the past decade, restraints on geographic expansion and product diversification are still very real. Not one banking company in the country can claim to be national in scope, taking deposits from, and making loans to, the country as a whole. Where consolidation has been achieved, it has tended to be consolidation within a state or, at most, one region, so that the institution is not insulated from regional shakeouts.

Another path to consolidation, offering consumer products by direct mail across state borders, bypasses the need for branch systems and loan production offices. The credit card business, for example, has undergone substantial consolidation, with a handful of providers taking meaningful market share, and consequently benefiting from economies of scale as well as diversification.

The troubled condition of the thrift industry could mean consolidation in deposit taking and single-family residential lending, since commercial banks are positioned to benefit from the shrinkage in thrifts. Banks have received a large proportion of deposits sold by the Resolution Trust Corp., and many banks have stepped up their origination of mortgages. This, combined with increased purchases of mortgage-backed securities, has alleviated the asset risk at many banks, restoring a measure of stability as other parts of the portfolio become more risky.

The downsizing of the thrift industry and the elimination of many irrational competitors allow surviving depositories, whether commercial banks or healthy thrifts, to improve their deposit pricing in many markets.

As a practical matter, restraints on product diversification remain. While bank holding companies may establish section 20 subsidiaries that are free, within limits, to pursue underwriting previously forbidden to banks, this approach lacks the flexibility that European universal banks, for example, enjoy. Firewalls between a holding company's bank and broker dealer affiliate are intended to protect the bank from risks at the broker dealer.

However, denying the broker dealer access to the bank's liquidity limits synergies; essentially separate operations happen to be owned by the same holding company. Whatever the justification for this approach, it is not likely to put U.S. banks on an equal footing with the European universal banks that effortlessly combine both commercial and investment banking functions. Similarly, commercial banking forays into insurance products remain just that. The possibility of meaningful consolidation of insurance and banking services is hindered by regulatory barriers that are just now being challenged.

In the meantime, heightened regulatory scrutiny of banks, however painful in certain cases, should provide an accurate perception to the public of banks' portfolios. This discipline should also sharpen bank underwriting standards, help restrict overlending to risky sectors, and perhaps prevent some costly mistakes. As long as this scrutiny is applied evenhandedly, both the public-banking customers-and the banks themselves should be better off.

Determined regulatory efforts to preserve the value of banks,in preference to their holding companies, particularly by tightening control over the flow of dividends to the parent company, underscore the need to distinguish the credit of bank holding companies from that of their banking subsidiaries. Standard & Poor's has long distinguished between holding companies and the banks that they own by notching down ratings on holding company debt when double leverage is unacceptably high. However, tolerance for any double leverage at all has become increasingly difficult to justify absent strong mitigating circumstances. Holding company debt that depends on dividend upstreaming for servicing is inherently risky when regulators are considering tightening restrictions on these flows.

Despite difficult conditions, the U.S. banking industry retains considerable strength. Banks have been innovative in finding new technologies to serve both individual and corporate clients, and have shown a willingness to invest in new products. The industry also has taken the opportunity to diversify and expand within the constraints of the legal framework, and probably will respond to new opportunities as the law permits. Competitive pressures have sometimes resulted in excessive asset risk, and some banks have failed to protect themselves with adequate reserve and capital policies. But competitive pressures have also prompted the industry, for example, to make the transition to a transactions-based business from relationship banking by developing innovative risk management products.

To some extent, the problems that confront the industry can be addressed through management policies: more conservative capital and reserve policies, more diversification, and less emphasis upon expanding riskier assets, all are within the purview of management control.

Money Center Banks

Just as bankers were about to heave a sigh of relief that the tide of lesser developed country (LDC) difficulties was receding, they turned to see another wave of asset quality problems looming overhead. Money center banks weathered the LDC crisis much as anticipated in their relatively high ratings. During the debt crisis, a combination of regulatory forebearance--which granted them time to build equity and reserves slowly--and superior access to money markets allowed the banks to raise equity despite their problems. Most now have the reserves necessary to absorb any further write-offs that might be required for remaining LDC debt, a life-threatening proposal five years ago. The new difficulties are emerging on the domestic front, in real estate loans and highly leveraged transactions (HLT).

The banks are less well braced against this new onslaught, with weakened equity and reserves against domestic loans. This has caused their ratings to drift down modestly over the course of the year. In addition, core profitability is being squeezed not only by asset quality problems but also by an unfavorable rate environment and a sharp falloff in corporate finance activity. Not surprisingly, a spate of cutbacks in wholesale banking has been announced. Increasingly, retail banking sectors are carrying consolidated profitability. Those banks with large consumer banking franchises are therefore relatively advantaged. Money center banks by and large do not have the strong retail presence the regionals do, however.

One trend is working to the advantage of money center banks. Certain retail banking products, such as credit cards, mortgage banking, and student loan servicing, are subject to economies of scale and are consolidating rapidly. The money centers have significant competitive advantages in these areas because of their size and technological expertise.

As agent banks in leveraged buyout finance, money centers originate far more loans than they keep, doing fee business on high asset turnover by distributing much of the credit risk through syndication. Most important, the riskiness of these loans is tempered by their senior, and generally secured, nature. In addition commercial bank portfolios generally are well diversified; most money centers have approximately 200 HLT loans, most of them under $50 million apiece. At any one time, however, the banks may have three to five positions over $100 million in the process of being sold down. On these, the banks bear the underwriting risk. Indeed, large loans that hit snags during the sell-down period generally are responsible for the recent, high non-performing ratios at some banks.

Asset quality in HLT portfolios has deteriorated sharply since mid-1989. Nonperforming assets have topped 10% (on core leveraged buyout loans) at some institutions, up from 3% a year earlier, although there is wide disparity among banks on this score. Significant charge-offs also have begun to appear.

Given the number of loans in trouble or need of restructuring, Standard & Poor's expects nonperformers to rise beyond current levels, though perhaps in a bumpy fashion as large loans move in and out of the nonperforming category. The good news may be that the downcycle is likely to be of limited duration. Current problems are with loans originated in the overheated late 1988 and early 1989 period. Struck at ever-increasing multiples of cash flow, with thin to nonexistent coverage of interest costs, these transactions left no room for an economic slowdown. The few loans being done now appear to be structured more conservatively, with larger equity cushions, holding out the possibility that credit quality may return to normal when the 1988-89 bulge works its way through the system.

Historically, HLT loan quality had been excellent, with very few nonperforming loans and charge-off averages no worse than other commercial loans. However, last year's charge-offs were already two or three times higher than any previous levels- touching 3.5% of loans at some banks. Charge-offs will likely remain high over the next few years. While senior secured creditors undoubtedly fare better in a bankruptcy or restructuring, anecdotal evidence suggests that charge-offs can still be substantial, perhaps averaging 30%-40% of troubled loans. Another major factor in losses is whether a full-scale recession will develop, which would push many loans over the brink of insolvency.

Quite apart from credit quality, HLT profitability is deteriorating along with sharply diminished number of loans, reducing fee income. Given this low level of fee income, should loss levels rise above 1.5%, the normal spread at which loans are priced, the business may even become unprofitable.

The money center banks have tried to enhance the profitability of their HLT portfolios by participating in the subordinated debt and equity portions of these transactions. Collectively, the nine money centers have $3.4 billion in equity and subordinated debt. Few banks invest substantial amounts in loans where they also hold senior portions. Much of the equity participations are through funds, in fact. Thus, the limited risk of equitable subordination should not arise. While obviously far riskier than senior debt exposures, these investments are well diversified. They are carried at cost, with quite small individual positions. While gains on these portfolios are volatile, they have been substantial and generally have trended up. Realized gains have swamped small losses, and remaining unrealized gains are substantial.

During the current down cycle, real estate problems have percolated up to the largest national developers, the money centers' clients. These developers generally have greater industry expertise and financial power to withstand cyclical downturns than local developers, the regional banks' customers. The money center banks also differ from the regional banks in that their portfolios are better diversified geographically. Most importantly, commercial real estate represents a smaller proportion of their loan portfolios than at the regional banks, falling between 10% and 17%, whereas large regional banks average 25%-30%. Thus, by themselves, real estate lending problems should prove less devastating for money center banks than they have for regionals.

That said, asset quality problems have become serious in money center bank real estate portfolios over the last year and a half, with most of the deterioration in the Northeast. More deterioration is likely. The uptrend in nonperformers has been more gradual than at some of the regionals.

The LDC problem, now of eight years duration, is waning but still noteworthy. Regulatory forbearance on this issue has allowed banks the time to build the capital and reserves necessary to absorb write-offs. In last year's round of reserving actions, money center banks added about $8 billion to LDC reserves. However, both the financial condition of LDC countries and their willingness to pay has deteriorated over the last two years. The Standard & Poor's model indicates the need for 52% reserves against term loans under current economic conditions, up from 41% two years ago. Standard & Poor's believes that short-term credits, representing substantially less risk than term loans, should be reserved at half that level. In addition, reserve levels on nominal outstandings have become a less adequate yardstick since last year's chargeoffs against Argentine exposure, and the exchange of debt for Brady-plan Mexican bonds. Taking those charge-offs into account, the model indicates the need for about 39% against remaining outstandings.

Adjusted for these events, reserves are fairly close to re-required levels. It now appears that the heaviest aspect of the LDC burden is the continual drag on earnings as one or another country is in arrears on its interest payments or negotiates a reduced rate. Equity levels have also improved significantly, offsetting remaining loss potential in LDC loans.

Tax credits resulting from the reserves represent an additional financial resource. Most banks have been slow to recapture these tax benefits because they need to realize the losses and have foreign source income in excess of domestic to preserve these tax benefits and foreign tax credits. If capital is credited with the present value of tax benefits (including those that would be derived from appropriate additional reserves), assuming they are realized over the next five years, common equity would be restored to about 5.5%.

The money centers have also reduced their LDC exposure through swaps, sales, and ATRR charge-offs. Total outstandings have dropped to $46.4 billion from $60 billion in 1987, and should fall steadily in coming years. Equity investments are becoming significant. Particularly after the large Argentina debt for equity swaps. The inherent risks in these investments will require close monitoring.

Quite apart from difficulties on the credit front, money centers have been suffering a drag on core profitability from the wholesale banking operations. Wholesale banking has been a declining industry for the past decade. Large, well-known corporations, the historical mainstay of money center banks, often with higher credit ratings than the banks themselves, no longer need the banks to serve as intermediaries, but can borrow directly in the capital markets. Until recently, money center banks have coped rather well by essentially reinventing wholesale banking, focusing on interest rate and currency risk management products, and on advisory services. Loan sales increased asset turnover, creating a lucrative fee generating business to augment skimpy spreads on high quality loans. Trading operations grew to provide substantial earnings for some banks.

Once again, banks are being called upon to reinvent themselves. The old-line credit businesses, even specialty areas, such as real estate and HLT financing, no longer provide attractive returns. These lending areas are now at a standstill for the foreseeable future, and could generate credit losses that will plunge the whole sector into unprofitability. Not surprisingly, a spate of restructurings was announced in the first half of 1990, aimed at removing excess capacity.

To counteract waning profits from wholesale banking most money centers have have recently emphasized retail banking, elevating executives from that area to posts of president and chief executive officer. The New York and Illinois money centers remain relatively disadvantaged in branch banking, remaining virtually locked into their home states, with networks of about 200-300 branches, compared to triple that number at California banks. Any out-of-state presence tends to be patchy and does not make a great deal of sense as a franchise addition. Unfortunately, the money centers lack the capital necessary to make the substantial acquisitions now permissible under liberalized legislation, and their low stock prices preclude stock financed transactions. With a few exceptions, these banks will have to develop existing retail franchises or marketing products which do not require a branch delivery system: credit cards, mortgages, consumer loans, and private banking services. Under this strategy, the banks would benefit from their size, reaping the sizable economies of scale inherent in those businesses, and taking advantage of the trend towards consolidation in these areas. Credit cards in particular have been the driving engines of their retail banking earnings growth.

The newly permissible powers to underwrite municipal revenue bonds, asset-backed securities, commercial paper, and corporate debt have not been a significant factor in earnings, nor have they been a concern in ratings thus far. Generally, these section 20 subsidiaries are at a break-even point or losing money, depending on what business lines have been included in them. No one seems to be making money underwriting. Partly this is because in the initial start-up phase underwriting requires heavy investment in systems and personnel. Partly, too, margins in the permissible activities have all but disappeared. Any positive impact from new powers seems at least a few years down the road. Meanwhile, the subsidiaries are overcapitalized relative to their risk profiles. Should these businesses grow to substantial proportions, they would tend to put downward pressure on ratings.

Regional Banks

Traditionally, money center and regional banks focused on different activities and strategies, but their operations are beginning to converge. Money centers are moving into regional roles as competitive factors force them downmarket to seek retail and lower middle-market business that once was the domain of the regional banks. Conversely, the larger regional banks are reaching upmarket to the larger corporate customers, and expanding their fee-based activities like trading, brokerage, and national syndications. Currently, most money center banks retain an advantage in their scope of operations, global funding ability, and portfolio diversity. However, they have infrastructure and competitive advantages that can be utilized fully only in international and national activities. Superregional banks, in contrast, have a competitive advantage at regional and local levels where they have cultivated long-term relationships with desirable middle-market and retail customers, and where they have extensive branch networks in place. This decade, if the industry continues to consolidate, the two groups may compete to establish superiority in overlapping markets and business lines.

Superregional banks have grown rapidly over the past five years, adding value by entering new markets and diversifying their asset and funding mixes. In expanding geographically, they had a distinct advantage over the money centers, which were restricted by regional banking compacts and LDC problems. Yet, at the same time, many regional banks also increased their financial leverage, diluted earnings and asset qualify measures, and stretched their managerial resources. Evidence is mounting that a drive for growth to offset dilution is contributing to current asset quality problems. For the most part, significant cost savings have yet to materialize, and reporting systems and controls are still being phased in. Few regional banks offer common products throughout their franchise systems, greatly reducing a potential source of synergy. Like the money centers, the super-regionals have achieved economies of scale in business lines with a national focus, such as trust and mortgage banking operations.

However, crossing state lines has not generated substantial economies of scale in basic banking businesses, since the acquired companies usually operate in distinct banking markets where consolidation of operations is impossible or undesirable because of customer needs.

Asset quality challenges are the foremost obstacle to the large regional banks' strategic plans. Despite their rapid expansion, few of the banks were able to diversity out of their own regions, and thus remain vulnerable to the same regional economic vagaries as before. No region is immune from the problems in real estate and HLTs now confronting the industry. Real estate difficulties are most severe now for New England banks, but are common all along the east coast where growth in real estate portfolios and markets was substantial until recently. While most markets in the Midwest never experienced a similarly rapid rise in real estate values, a number of Midwestern regional banks are also experiencing greater arrearages in real estate loans as pockets of weakness appear in some metropolitan markets. The Southwest is showing signs of recovery, but the effects of the real estate depression will filter through the portfolios of the regional banks there for years to come. Markets in California and the Pacific Northwest remain strong, but have all the earmarks of overheated activity last seen along the east coast. Standard & Poor's expects non-performing real estate assets to surface in those Western regions as well, once those markets begin to cool.

A number of large regional banks also have sizable exposures to highly leveraged transactions, increasing their vulnerability to asset quality deterioration. Larger lending limits and greater emphasis on fee generation enabled these banks to participate in the origination and syndication of HLT loans to an increasingly greater extent. The overall effect of HLT weakness on asset quality and earnings will not be as detrimental at regional banks as at money center banks, since overall exposures are smaller, but the impact will compound problems stemming from the real estate cycle.

Most regional banks no longer are rewarded by the markets for their pristine balance sheets and asset quality. The wide window to capital markets that was opened in the mid-1980's has been closed to all but the strongest regionals. International and domestic access has been reduced for money center banks as well, but the money centers still retain a slight advantage in their global capital-raising ability.

Competitive, regulatory, and economic pressures are forcing regional banks to implement oversight controls and conservative disciplines that will, over the longer term, strengthen regional banks as a group. Over the past five years, the regional banks have greatly improved their management tools, installing better information, asset/liability management, loan monitoring, and communications systems.

But there are wide disparities with the use of these systems. Many regional banks still cannot aggregate such fundamental and increasingly important information as real estate or commercial loan exposures across their multibank systems. In contrast, most money centers have both the systems and controls largely in place. The reduction in overcapacity in the banking industry, coming mainly from the shrinkage in the thrift industry, will be positive for all banks, but probably will benefit the regional banks to a larger degree. Smaller banks and thrifts are far more likely to be absorbed by the regional banks, whose branch strategies and corporate cultures are more similar. Additionally, money center weaknesses and new capital guidelines will limit them from participating in all but the most favorable circumstances. More rational pricing on both the lending and funding sides, and market share improvement from the ongoing absorption of new franchises by the regional banks, will strengthen the banks over the long run. The key will be in leveraging these expanded distribution systems and rationalizing expenses to keep earnings on track and offset the negative impact of asset quality problems.

Thank you, Mr. Chairman. This concludes my prepared statement; I would be happy to answer any questions you or members of the Committee may have.

S&P'S DEBT RATING DEFINITIONS

A Standard & Poor's corporate or municipal debt rating is a current assessment of the creditworthiness of an obligor with respect to a specific obligation. This assessment may take into consideration obligors such as guarantors, insurers, or lessees.

The debt rating is not a recommendation to purchase, sell, or hold a security, inasmuch as it does not comment as to market price or suitability for a particular investor.

The ratings are based on current information furnished by the issuer or obtained by S&P from other sources it considers reliable. S&P does not perform an audit in connection with any rating and may, on occasion, rely on unaudited financial information. The ratings may be changed, suspended, or withdrawn as a result of changes in, or unavailability of, such information, or for other circumstances.

The ratings are based, in varying degrees, on the following considerations:

1. Likelihood of default—capacity and willingness of the obligor as to the timely payment of interest and repayment of principal in accordance with the terms of the obligation.
2. Nature of and provisions of the obligation.
3. Protection afforded by, and relative position of, the obligation in the event of bankruptcy, reorganization, or other arrangement under the laws of bankruptcy and other laws affecting creditors' rights.

Investment grade

AAA Debt rated 'AAA' has the highest rating assigned by Standard & Poor's. Capacity to pay interest and repay principal is extremely strong.

AA Debt rated 'AA' has a very strong capacity to pay interest and repay principal and differs from the highest rated issues only in small degree.

A Debt rated 'A' has a strong capacity to pay interest and repay principal although it is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.

BBB Debt rated 'BBB' is regarded as having an adequate capacity to pay interest and repay principal. Whereas it normally exhibits adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for debt in this category than in higher rated categories.

Speculative grade

Debt rated 'BB', 'B', 'CCC', 'CC', and 'C' is regarded as having predominantly speculative characteristics with respect to capacity to pay interest and repay principal. 'BB' indicates the least degree of speculation and 'C' the highest. While such debt will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major exposures to adverse conditions.

BB Debt rated 'BB' has less near-term vulnerability to default than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to inadequate capacity to meet timely interest and principal payments. The 'BB' rating category is also used for debt subordinated to senior debt that is assigned an actual or implied 'BBB–' rating.

B Debt rated 'B' has a greater vulnerability to default but currently has the capacity to meet interest payments and principal repayments. Adverse business, financial, or economic conditions will likely impair capacity or willingness to pay interest and repay principal. The 'B' rating category is also used for debt subordinated to senior debt that is assigned an actual or implied 'BB' or 'BB–' rating.

CCC Debt rated 'CCC' has a currently identifiable vulnerability to default, and is dependent upon favorable business, financial, and economic conditions to meet timely payment of interest and repayment of principal. In the event of adverse business, financial, or economic conditions, it is not likely to have the capacity to pay interest and repay principal. The 'CCC' rating category is also used for debt subordinated to senior debt that is assigned an actual or implied 'B' or 'B–' rating.

CC The rating 'CC' typically is applied to debt subordinated to senior debt that is assigned an actual or implied 'CCC' rating.

C The rating 'C' typically is applied to debt subordinated to senior debt which is assigned an actual or implied 'CCC–' debt rating. The 'C' rating may be used to cover a situation where a bankruptcy petition has been filed, but debt service payments are continued.

CI The rating 'CI' is reserved for income bonds on which no interest is being paid.

D Debt rated 'D' is in payment default. The 'D' rating category is used when interest payments or principal payments are not made on the date due even if the applicable grace period has not expired, unless S&P believes that such payments will be made during such grace period. The 'D' rating also will be used upon the filing of a bankruptcy petition if debt service payments are jeopardized.

Plus (+) or minus (–): The ratings from 'AA' to 'CCC' may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

p The letter 'p' indicates that the rating is provisional. A provisional rating assumes the successful completion of the project being financed by the debt being rated and indicates that payment of debt service requirements is largely or entirely dependent upon the successful and timely completion of the project. This rating, however, while addressing credit quality subsequent to completion of the project, makes no comment on the likelihood of, or the risk of default upon failure of, such completion. The investor should exercise his own judgment with respect to such likelihood and risk.

i The letter 'i' indicates the rating is implicit. Such ratings are assigned only to governments that have not requested explicit ratings for specific debt issues. Implicit ratings represent the sovereign ceiling or upper limit for ratings on specific debt issues of entities domiciled in the country.

L The letter 'L' indicates the rating pertains to the principal amount of those bonds to the extent that the underlying deposit collateral is insured by the Federal Savings & Loan Insurance Corp. or the Federal Deposit Insurance Corp. and interest is adequately collateralized. In the case of certificates of deposit, the letter 'L' indicates that the deposit, combined with other deposits being held in the same right and capacity, will be honored for principal and accrued pre-default interest up to the federal insurance limits within 30 days after closing of the insured institution or, in the event that the deposit is assumed by a successor insured institution, upon maturity.

***** Continuance of the rating is contingent upon S&P's receipt of an executed copy of the escrow agreement or closing documentation confirming investments and cash flows.

N.R. Indicates no public rating has been requested, that there is insufficient information on which to base a rating, or that S&P does not rate a particular type of obligation as a matter of policy.

Debt Obligations of Issuers outside the U.S. and its territories are rated on the same basis as domestic corporate and municipal issues. The ratings measure the creditworthiness of the obligor but do not take into account currency exchange and related uncertainties.

Bond Investment Quality Standards: Under present commercial bank regulations issued by the Comptroller of the Currency, bonds rated in the top four categories ('AAA', 'AA', 'A', 'BBB', commonly known as "investment grade" ratings) generally are regarded as eligible for bank investment. Also, the laws of various states governing legal investments impose certain rating or other standards for obligations eligible for investment by savings banks, trust companies, insurance companies, and fiduciaries generally.

STATEMENT OF ROBERT EISENBEIS, WACHOVIA PROFESSOR OF BANKING, UNIVERSITY OF NORTH CAROLINA AT CHAPEL HILL

Mr. **Eisenbeis**. Thank you, Mr. Chairman. I appreciate the opportunity to be here.

When I was initially requested to come, it was with the view to expressly comment on a couple of research studies that some colleagues and I had done which looked at a special group of institutions, commercial banks who had voluntarily specialized in real estate lending over the last 10 years or so.

I prepared my comments with that request in mind.

However, in addition, a number of key issues have arisen at the hearings both today and other times concerning the safety of the FDIC fund, the need to embark on policies to permit weak and insolvent institutions to continue to operate rather than closing them, so-called forbearance, and the need to reform the regulatory and supervisory policies to assure that the problems in the thrift industry don't occur again.

I'm a member of the Shadow Financial Regulatory Committee, a self-appointed group, so to speak, of economists and former government officials who have been speaking out since about 1986 on a number of these issues. And, indeed, we have addressed all the issues that have come up and that I've enumerated before.

Hence, I would be in a position, and welcome the chance, to share some of our views on those issues.

With that preface, I'd like to place my initial comments in the record, as well as the studies that I have prepared, and then briefly summarize what some of the key results were I was pleased to see that Senator Garn, in his opening remarks, had in fact hit upon what we thought was one of the key points that we had discovered in looking at this unique group of banks.

What I'd like to comment on first is what we've learned about the riskiness of real estate lending as a whole because a lot of people have been talking about that; second, how these real estate specializing institutions have performed when compared to more diversified financial institutions, and finally, what guidance this kind of work has provided for us as we face the problems of restructuring financial institutions as a whole.

First, I'd like to mention that we looked at three different classes of banks, from the 1978 to 1988 period. We looked at a sample of control institutions that was selected to be representative of commercial banks as a whole, And then we also looked at two specialized groups of institutions, both of whom held more than 40 percent of their assets in real estate loans.

One of those groups of institutions were so-called long-term specialized institutions. They had held portfolios of that nature for 5 or more years, and many had held that proportion for much longer than that.

There are a couple of observations about the sample which I think are interesting.

First of all, we found that the number of these institutions, particularly in the broader real estate specializing sample, fluctuated quite a bit. We had 956 of these institutions in 1978; not an insignificant number of banks. They declined steadily to about 200 in

1983, and then just about the time that we started to hear about all the problems in real estate lending, we saw these institutions steadily start to increase in number until, by 1988, there were 1328 banks.

Interestingly enough, this represented a decision on the part of institutions to get into the real estate lending market right at the time when thrifts were being forced out because of the profitability problems that they were experiencing.

The second observation about the sample that I think is where these institutions were coming into business. In fact, they were leaving the real estate business in the Midwest and the central part of the country, particularly in Wisconsin and Minnesota and some of those areas, and they were coming into the real estate business in those very States and areas of the country that were experiencing the most difficulty—namely, Texas, California, and Florida.

This suggests that, the market responses to opportunity. It is not true that the market as a whole, was bad or that there weren't good credits in these areas where institutions were having trouble. Instead, participants in the market would step in and start to provide the funds necessary to supplement the loss in the markets that the thrift institutions caused by disappearing.

The CHAIRMAN. Now that time period was the early part of the 1980's?

Mr. EISENBEIS. No, the real estate banks started to come into existence from 1983. There was a steady decline up until 1983.

The CHAIRMAN. Right.

Mr. EISENBEIS. From 1983, there's been an increase every year.

The CHAIRMAN. Since 1983.

Mr. EISENBEIS. Yes, sir.

The CHAIRMAN. So you're saying 1983 through, in effect, 1989, 1990.

Mr. EISENBEIS. That's right. Which is an interesting observation. And now we have got 1,300 banks, which is roughly 10 percent of the banks in the country, falling into this class. And I might add that these don't include those thrift institutions that converted to a commercial bank charter. We didn't look at those, nor at some of the special nonbank banks.

The CHAIRMAN. Let me give you something—think about this as you answer here.

Mr. EISENBEIS. Sure.

The CHAIRMAN. Look at the profile of the S&L's in those States that were the big real estate States problems are and you just ticked them off—California, Texas, and Florida—and, recipients of the transcontinental migration from the upper Midwest. Most of those States, at least California and Texas, had State charters for S&L's that allowed, even encouraged going deep into real estate. That today is a major part of the problem.

As the S&L's tanked on real estate in those regions of the country, a lot of those assets have since come into the RTC. Banks may have gotten sucked into that in the jet stream of the S&L's.

Now, qualitatively, they may have done better, worse, or about the same. I'm wondering if, the problem that helped sink the S&L's in those States might not now have the same potential to sink some fair number of banks in exactly those same areas for the same reasons?

Mr. EISENBEIS. I think I can address that because we specially looked at those institutions in Texas. First, let me tell you what we found generally, and then I can come back to that.

The CHAIRMAN. Yes, please. Very good.

Mr. EISENBEIS. I think it will put some of this into a little bit better perspective.

The CHAIRMAN. Right.

Mr. EISENBEIS. The first observation I'd like to make is pertaining to what we discovered about the risk characteristics of real estate institutions as compared to regular commercial banks.

A general observation that we noticed was that over this entire period, banks as a whole became more risky, a concern that we've been talking about today, regardless of whether they were specializing in real estate lending or not.

Second, after 1983, when difficulties became evident in the real estate markets, our sample of real estate banks, appeared to be no more risky, and, in fact, less risky than regular commercial banks.

This favorable performance held up when we looked at loan loss experience, when we looked at past-due loans, when we looked at repossessions, as well as aggregate measures of the overall riskiness of these institutions.

These differences in risk were also reflected in lower failure rates. These institutions had lower failure rates than regular commercial banks as a whole; 3.1 percent of these institutions failed as compared with 5.4 percent for commercial banks as a whole.

Thus, these samples of banks that we looked at, while they had a substantially higher proportion of their assets in real estate loans, were, on average, substantially less risky. They were not only less risky in their real estate loans, but their commercial loan portfolios that they held were also less risky than the commercial loan portfolios of regular commercial banks.

In terms of profitability, the net return on assets of regular commercial banks, up until about 1983, was higher than our real estate banks. After that, the real estate banks in the sample outperformed regular commercial banks. Our analysis suggests that the superior operating performance in terms of return on assets came from the higher returns on less risky assets and not from a cost advantage in terms of either interest costs or noninterest operating expenses.

Turning to the breakdowns of what kinds of real estate assets they were holding, there's several points that I'd like to make.

First, as to be expected, they obviously had a higher proportion of real estate loans in their portfolio than regular commercial banks and a significantly higher proportion of these real estate loans were in one to four family loans.

Second, that was the source of the additional funds; what sorts of assets did they give up in order to take on more of these residential real estate loans?

Generally, they gave up assets that would be regarded as more liquid in a commercial bank portfolio—consumer loans and loans in the other asset category.

Third, although construction and land development loans, the cause of many significant problems in S&L's, increased in both the samples of our real estate and commercial banks, the ratio never exceeded 15 percent of real estate loans for our real estate banks, and for the longer term specialized institutions, they had an even smaller proportion—9 percent of their assets were in these commercial and development loans, which is where the real problems are, not in the one to four family.

Overall, I think we could say that their higher profitability was due to the fact they had less risky assets and in fact, they had higher yielding assets as a whole than the more liquid assets that regular commercial banks had.

Many of these institutions operated, to some extent, we thought, in perhaps more benign real estate markets than in some of the severe cases that we looked at.

We felt that there was a real question as to how these institutions would perform in time of real crisis. For that reason, we turned and looked at the Texas situation for clues as to how these institutions might perform in a real difficult time.

We discovered that, unlike our national samples, the Texas real estate banks performed about the same as did regular Texas banks from 1983 to 1986.

Second, thereafter, they performed slightly marginally worse—about 4 basis points, which is almost a trivial difference.

Part of this performance may have been due to the fact that these institutions held a smaller proportion of their real estate loans and one to four family loans than our sample as a whole and commensurately a higher proportion of the commercial real estate, those areas that we're most concerned about.

I think that may be an important clue.

On the other hand, Texas real estate banks had lower failure rates than did Texas commercial banks as a whole. And in general, the Texas banks that failed because of real estate were not among our sample of specialized institutions.

The message here is if you're going to tank an institution, you can tank it without having a large concentration of real estate loans. You can do it with a little if you have the wrong kind.

In short, I think our analysis tended to confirm our earlier conclusion that specialization in real estate is not inherently risky by itself.

Our research suggests that these institutions can be economically viable, even without the special subsidies that we have historically provided to S&L's.

I might add that this conclusion is quite robust because not only did we look at the period 1978 to 1988, but we also, in a previous study, looked at these same kinds of institutions from 1970 to 1977.

We now have a 20 year history for a fairly large group of institutions that made as specialized real estate lending institutions, and they did very well.

In conclusion, I'd like to mention a couple of points because I think the work highlight what I think are two important issues.

First this specialization occurred as thrifts were leaving the industry. This provides some indication that private markets will work to move in and take up the slack. This, together with other significant changes that have taken place in the real estate markets as a whole, such as the growth of mortgage banking activities and securitization—and I understand about 75 percent of all home mortgages are now securitized—means that the policy prescriptions and so on that you consider shouldn't be constrained by your concern about who's going to provide the funds for housing.

Let's clean up the thrift mess. Housing will probably take care of itself because those markets have changed significantly. Don't let concerns for housing be a constraint on what you do.

The second point that I would like to raise goes to Senator Garn's opening remarks, and that was, FIRREA required S&L's to increase their specialization and traditional real estate lending.

One shouldn't assume that just because these banks we looked at chose to specialize in real estate, that they're just like S&L's.

Indeed, they weren't. They were much less concentrated in mortgage lending by some 20 percentage points than S&L's as a whole. This lower overall percentage, plus the freedom that they had to shift their portfolios as economic circumstances determined, allowed them to weather a lot of the problems that S&L's, by virtue of the asset regulations they were under, could not do. While an institution can make it as a real estate specializing institution, it can't do so and be as specialized as an S&L. You've got to strike some medium that's much less specialized than we have in S&L's.

I'm concerned about the provisions of FIRREA that force S&L's into an even greater portfolio imbalance and I'm concerned about what that's going to mean.

Last, I'd like to turn and make just a couple of observations about some of these other——

The CHAIRMAN. I'm going to have you do that in just a minute because I want to leave time for Senator Graham's questions.

Go ahead.

Mr. EISENBEIS. Sure. It will take me just a couple of minutes.

First of all, there's been a lot of attention addressed to the question today of the adequacy of the FDIC fund. The Shadow Committee, the Shadow Financial Regulatory Committee that I'm a member of, expressed its own concerns about the fund in a policy statement in December 1988, as did the GAO.

At that time, we estimated that the fund was in difficulty for exactly the same kinds of reasons that the CBO and GAO have been expressing—there are unrecorded losses, the FDIC has not anticipated besides those losses in institutions they identified as being very likely to fail, and they didn't apply, we don't think, the correct loss rates in estimates the losses that they were exposed to.

We need to be pursuing exactly the kinds of analysis and methodologies that we've seen presented yesterday and today. The CBO and GAO people are doing it essentially right.

Concern about the FDIC fund should not be new news. This is news that people have started to be worried about. Now is the time to be concerned, not after the problems are on the table. It's not a new problem. It's been around for sometime. People have known about it. People have been talking about it. And now is the time to act.

I also understand that Chairman Seidman suggested it might be necessary to keep insolvent or weakly capitalized thrift institutions open, instead of reorganizing them, due to the lack of sufficient funds in the FDIC to resolve these cases.

I would urge you strongly to resist that temptation. Such forbearance—I know people are not pleased with the use of that word—is why we got into trouble with the S&L industry. And if we continue it, we'll only increase the size of the losses that we face down the road.

Someone said, we need a new word for "forbearance." OK, I'll give you that word. It's speculation. It's speculation by the Government with the taxpayers' money that things will work out in the end.

I don't think that's a business that we want to be in, at least if we're concerned about the interests of the taxpayer.

The CHAIRMAN. Now let me just draw you out just another minute on that.

Mr. EISENBEIS. Yes, sir.

The CHAIRMAN. I know you're expressing a personal professional opinion on that point.

Mr. EISENBEIS. Sure.

The CHAIRMAN. But are you saying as well that your study, analysis, and data would support that view that forbearance is 8 times out of 10 or—9 times out of 10 or 10 times out of 10—not a prudent course?

Mr. EISENBEIS. Yes, sir, I do. And I think, as a footnote to that, people have urged preventive actions like early intervention and so on, which is a key element in a reform proposal that we—The Shadow Committee—came out over a year ago. It included early closure and intervention, increased capital, increased supervision and monitoring, are the keys.

I think the point can't be emphasized enough that we don't lose a dime if we close institutions before their net worth goes to zero. The fact that you see losses appearing in the FDIC fund means that they didn't close those institutions on time.

That's the cost of an improperly functioning and inadequate monitoring system. If we have adequate monitoring such that we can make closure decisions ahead of time, it keeps these institutions from playing with the taxpayers' money.

In fact, if we always closed institutions before net worth went to zero, we wouldn't need a fund and we wouldn't need to worry about raising premiums.

Worrying about raising premiums says that we're going to keep doing what we've been doing before—not closing institutions. And that's the wrong policy.

I'm really anxious to talk about some more of these issues. Why don't I stop at this point and let you ask questions.

[The complete prepared statement of Robert A. Eisenbeis follows:]

Statement

by

Robert A. Eisenbeis

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before the Committee on Banking, Housing and Urban Affairs

United States Senate

September 12, 1990

I. Introduction

Problems in real estate lending have been on our minds for several years as we have faced the thrift crisis and the difficulties of disposing of the assets of those that have failed. Real estate problems have also contributed to the failure of many banks, most notably in Texas, and to the decline in perceived soundness of banks in other parts of the country, such as New England. Given this experience, there is substantial concern about the continued viability of specialized depository institutions, and most particularly of real estate specialized firms. Some observers maintain that the thrift industry, at least as the American economy has known it, is obsolete. Others argue that maintenance of specialized real estate depositories are vital to the continued flow of an adequate level of funds to housing. The crucial issues are whether depository institutions, forced by regulation to specialize in real estate lending, are economically viable on their own, and if they are not, then where will the funds to support housing come from?

In appearing before you today, I was expressly requested to comment on recent research that I and some colleagues have completed which address these questions.[1] Specifically we examined the performance of an interesting group of commercial banks that have voluntarily specialized in real estate lending over the past 11 years. In briefly summarizing this research, copies of which I have made available to the Committee Staff for inclusion in the printed version of the hearing, I will concentrate on what we have learned about the riskiness of real estate lending, how real estate specializing institutions might be expected to perform when compared with more diversified institutions, and what guidance this work provides as we face the problems of restructuring financial institutions.

II. The Sample Firms

In our research, we looked at the performance of three sets of commercial banks from 1978 through 1988.[2] Two of these samples were comprised of banks that had voluntarily specialized in real estate lending over the period, as distinct from thrifts who were forced to specialize in real estate lending by regulation and statute. Our first, and broadest, sample of real estate specializing banks (REBs) consisted for each year of those banks that held 40 percent or more of their total assets in loans secured by real estate. The second sample was comprised of those banks that appeared in our first sample for five or more years (5REBs). Finally, we compared these two samples with all other commercial banks.[3]

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[1] See Eisenbeis and Kwast(1982,1991), Eisenbeis(1982), and Eisenbeis and Horvitz (1990). The views expressed in this testimony are my own and should not be construed as representing the views of either my coauthors or the Board of Governors of the Federal System.

[2] In Eisenbeis and Kwast(1982) and Eisenbeis(1982) the data spanned 1970-1977.

A couple of observations are in order about how the composition of the samples changed over time. The number of REBs starts with a relatively large number of banks (956) in 1978, declines steadily to a minimum of 207 in 1983, and thereafter rises, reaching the maximum 1328 in 1988. This time pattern follows closely the trend in interest rates, with a slight lag at the trough. Interestingly, the number of banks which decided to specialize in real estate related lending increased, just as the rate of thrift failures began to accelerate. Moreover, there was a significant geographic shift in the location of the REBs away from the North Central part of the country, especially Wisconsin and Minnesota, and toward those areas that were experiencing, or would soon come to experience, serious problems in real estate lending, namely Texas, California, and Florida. This suggests that banks moved into the market as thrifts were leaving.

III. Risk Characteristics

I would like now to turn to what we found out about the risk characteristics of our banks. First, we noted that all banks over this period became more risky, regardless of whether they specialized in real estate or not. But surprisingly, after 1983 when difficulties began to be come evident in real estate markets, the sample of REB banks was no more risky than regular commercial banks, and the longer term real estate banks were less risky. The favorable performance of the real estate banks also held up when we looked at loan loss experience, past due loans, and repossessions. Loan losses were significantly lower for the two samples of real estate banks than for regular commercial banks over the entire period, and similarly, past due loans were also lower beginning in 1983 when the data first became available.[4] Finally, while repossessions as a percent of real estate loans more than doubled over the period, repossession ratios were only about a third that of regular commercial banks.

The differences in asset risk were also reflected in lower failure rates for the real estate banks. From 1979 through 1988, the failure rate of the REB sample was 3.1 percent, slightly over half the 5.4 percent ratoe fr the CB.[5] Thus, while the banks in the two real estate specializing samples held a significantly higher percentage of their total assets in real estate loans, these loans were, on average, substantially less risky than either the real estate or commercial loans held by less specialized banks. The result was that these specialized institutions were no more risky than regular commercial banks, despite the collapse that was happening in real estate over the period.

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[3] In this control sample, banks were excluded if they were larger in size than the largest real estate specializing bank.

[4] Losses were also lower for the REBs in the non real estate portions of their loan portfolios.

IV. Profitability and Operating Expenses

In terms of profitability, the years 1982-1983 were something of a watershed in the relationship between profitability at the two sets of real estate banks and other commercial banks. Prior to that time,the net return on assets was generally higher at regular commercial banks. But after 1984 the two samples of real estate banks outperformed regular commercial banks. Our analysis suggested that the superior ROA operating performance of the real estate banks came from higher returns on less risky assets, and not from a cost advantage in terms of either interest or noninterest operating expenses.

V. Asset and Liability Composition

Turning to the breakdowns of the principle asset holdings of the sample banks reveal several important differences. First, the real estate banks held more than twice the proportion of their assets in real estate loans than did regular commercial banks, and a significantly greater portion of these loans were in 1-4 families loans than for regular commercial banks. Second, the source of the additional funds allocated to real estate loans came from assets that regular commercial banks would have held in liquid assets and in the other asset category. Third, consumer loans declined proportionally for both real estate bank samples and for commercial banks over the period, and was generally lower for real estate banks than for commercial banks. Fourth, construction and land development loans, the cause of significant problems in many S&Ls, increased in both samples of real estate banks. However, the average ratio never exceeded 15 percent of real estate loans for the REBs, and 9 percent for both the 5REB banks and regular commercial banks.

Overall, the portfolio allocations suggest that the higher returns on assets for REBs are due largely to the shift in assets from lower yielding liquid assets into higher yielding mortgage loans. In addition, the churning of the real estate sample, and the increase in the number of banks from the low of 207 in 1983 do not appear to have been primarily the result of a shift in emphasis of real estate lending from residential to construction and land development lending. Rather, banks became specialized real estate lenders, taking up some of the slack in the 1-4 families loan market.

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[5] Only one REB failed before 1982, and 11 failed in 1987.

Finally, analysis suggested that, on average, banks which tended to specialize in 1-4 families mortgage loans were less risky than other real estate banks, and that, in particular, a move toward construction and land development loans tended to increase risk.

Another interesting aspect of the portfolio behavior of the REBs is the fact that they adjusted quickly their degree of concentration in real estate lending. This flexibility appears to be important to their ability to adapt to changing economic conditions, and this flexibility is lacking to traditional thrifts.

VI. The Texas Situation

While the research suggested that real estate specialization was not inherently dangerous, most of the institutions studied operated in generally benign real estate markets. There is a legitimate question of how well such institutions might hold up under extreme pressures. We looked, therefore, for clues in Texas, where the problems of real estate lenders have been the greatest. We felt that if there is a future for a specialized housing lending industry, then the harshest environment, and perhaps most interesting place to look for survivors and how they performed was in the ashes of the Texas collapse.

We discovered that unlike our national samples, Texas real estate banks performed about the same as did regular Texas banks between 1983 and 1986, but thereafter, they performed marginally worse. Part of this may have been due to the fact that the Texas real estate banks held a smaller portion of their loans in 1-4 families loans than did the national REBs. On the other hand, the Texas REBs had a significantly lower failure rate than did regular commercial banks. In general, the Texas banks that failed because of real estate lending were not among our sample or specialized institutions. In short, our analysis of the extreme situation in Texas tends to confirm my conclusion that real estate specialization by commercial banks in itself is not inherently risky.

VII. Summary and Conclusions

My research suggests that real estate specialized depositories are economically viable, even without the special subsidies provided savings and loans. This conclusion appears to be quite robust, in part because it is consistent with results from a similar study that we did covering the period 1970-1977. Thus, we now have over 20 years of documented superior performance of our REBs.

This work should also serve to highlight two important issues. First, the increased specialization in real estate that we observed occurred as thrifts were exiting the industry. This indicates that private market forces will move in to take up the slack in real estate lending. This, together with the other significant changes that have taken place in real estate lending, such as the growth of mortgage banking activities in numerous institutions and the role of securitization in reducing the importance of thrifts as portfolio investors, means that policy makers should not let concerns about providing funds for housing interfere with their attempts to resolve the thrift crisis.

Second, an important caution arises from this research, especially in view of provisions in the recently enacted FIRREA requiring S&Ls to increase their specialization in traditional real estate lending. One should not assume that, just because these institutions chose to specialize in real estate, they are like S&Ls. Real estate banks are much less concentrated in mortgage lending, by some 20 percentage points when compared to S&Ls. This lower overall percentage, plus the freedom to adjust their investments and the composition of their asset portfolios quickly in response to changing economic conditions, appears to be important to their survival. Given that thrifts have experienced so much difficulty over the 1978-1988 period, whereas the real estate banks in our studies have not, our research suggests that there may be practical limits to forced specialization, beyond which problems of lack of diversification may swamp the benefits of specialization. In short, the results of this study raise particular cautions about legislative and regulatory efforts to reduce potential diversification of thrift institutions as part of the reform of the thrift industry. Instead of attempting to legislate portfolios, greater attention should be placed on monitoring institutions for increased risk taking, requiring them to maintain adequate capital, and closing economically insolvent institutions before their net worth goes to zero, policies that should be the basis of financial reform.

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The CHAIRMAN. Senator Graham, I interjected before. Why don't you go ahead?

Senator GRAHAM. Thank you, Mr. Chairman.

I'd like to follow up on that last comment and the emphasis that you place on page 5 of your statement—instead of attempting to legislate portfolios, greater attention should be placed on monitoring institutions for increased risk-taking requiring them to maintain adequate capital, et cetera.

Mr. EISENBEIS. Yes.

Senator GRAHAM. Mr. DeStefano, you're in the business of doing that type of monitoring. Your clients depend upon the reliability of your advice for important investment decisions.

What advice would you give to this committee and to the Federal financial regulators as to how they could do a more appropriate job of monitoring?

Maybe we ought to contract that out to Standard & Poor's.

Mr. DESTEFANO. OK. I'm going to comment on that, but I have to come back to this issue of unrecorded losses and the whole area of forbearance because I think it's a much more complicated subject than a lot of the comments have suggested, and I think it could have policy implications that are negative for the creditworthiness of the industry, and I think it's related to this point.

I would agree with everyone else, that you want adequate recognition of problems in the banking industry insofar as that can be done.

The banks are supposed to report impaired assets. The issue that seems to have arisen recently is whether or not they're doing that and whether they're doing that on a voluntary basis or whether the regulators have to force them to do that.

Having——

Senator GRAHAM. If I could interject at that point.

Mr. DESTEFANO. Yes.

Senator GRAHAM. We heard yesterday some testimony to the effect that the standards of what is an impaired asset involve a range of judgment, and that those judgments have, in many instances, been I guess on the liberal side of the equation; that is, reticence to declare an asset as impaired.

You must face the same issue as you receive the financial reports from institutions. Based on your experience, how do you go about the process of looking behind the judgments that others have made in order to arrive at the independent evaluations of creditworthiness which you then pass on to your clients?

Mr. DESTEFANO. OK. We do rely upon audited financials and upon regulatory reports and take those very seriously.

What we would do, though, is sort of on a priori basis, assume that a class of assets has certain risk characteristics so that regardless of what the level of nonperformers is within that category, we would, at the beginning of our analysis, expect certain levels of equity and reserves to be maintained against that. And then we would look at that in the context of all the other business lines that the bank is engaged in.

However, one of the biggest problems that occurs in this approach of marking assets to market is that—the way markets work is that pricing is set at the margin. What was the last sale for this piece of property, for this loan, for this junk bond? And that tends to set what everybody's conception is for the value of that.

In a rising market, what that does is tend to inflate values. In a declining market, it tends to deflate them.

I think what we saw in the case of New England was when the regulators went in, they applied new standards—not new standards, but they applied the then-market standards to an existing portfolio that had been underwritten in a very different environment.

I think what they in effect told the institutions to do, or the message that the institutions received, was to in effect recognize the problems that were there and to reserve against them.

There is nothing wrong with that approach, and as a credit analyst, there's nothing that I'm going to say that would suggest that's incorrect.

However, what makes it so much more complicated is that—let me give you an example. When in late 1982, Mexico said it was not going to service its debt, if you had marked LDC debt to market at that point, based upon what the market was willing to pay for LDC, we would have had an insolvent financial system in the United States because the exposure in LDC was multiples of capital at that time.

Instead, the approach was one of forbearance and I think the approach was in effect, look, these are going concerns. These are institutions that are in a lot of business lines. These are institutions that have the capacity to overcome problems if we give them the time to do it, and that addressing of problems would be done through attempts to work out those loans, which did not work very successfully until recently. We've had some work outs through the Brady plan. But it also gave the institutions the time to generate earnings and to build reserves.

So that now, LDC, even under I think pretty severe worst-case hypotheses, is not a mortal blow to anybody within the U.S. financial system.

The **CHAIRMAN**. It won't take down the system.

Mr. **DESTEFANO**. Exactly. Whereas, if you had taken this approach of let's go in, mark the assets to market now on a liquidation value and then made the banks absorb that in their capital, you would have had what would have appeared to be an insolvent system in an accounting sense.

The only point I'm making here is that I think you do have to look, and I agree that we have to have the regulators in there and we have to have an accurate view of what's going on. And you would like to see that done before the problems develop, with adequate reserve and capital policies, to absorb the problems as they emerge.

But I do think that the approach of as soon as a problem, a category of assets emerges as a problem, you rush to market those on what somebody else is willing to pay on a liquidation basis, you're going to have a tumultuous sense of the U.S. banking industry which I think would be misleading, because it does have the capacity to work through problems if given the time.

I think the thrift case is just a very different one that does not counter what I just said. The thrift problem is they went in with no capital. There was no capacity to absorb problems. No matter when or whenever you mark them to market, there was no capital.

But when you have capital, before you go into the problems and you have reserves before you go into the problems, I'm not sure that you want the banks to be marking everything to market as soon as the problems emerge because there's a real question of what market you're referring to. I mean, what is this real estate worth today? Or what is this bond worth today? Or what is this LDC loan worth today?

Basically, what you're saying is what is somebody going to pay for this if I have to liquidate it today? And that is a rigorous standard, but I'm not sure that in practice that's what we want to see because I think it could give a misleading impression of how strong or how weak the system is as a whole.

And I don't think the insurance fund wants to walk into the situation every time and say, stop, mark to market. The problems are here. They overwhelm capital. And therefore, you're out of business. Because, again, I think the analogy or the example of LDC, if it had been approached like that, would have led to very difficult results.

This is maybe a strange remark for a credit person to say. I'm not in any way saying that we don't want rigorous accounting standards. We do. But I think the question of rigorous accounting standards has to be conceptualized in terms of are we looking at a liquidation scenario or a going concern scenario?

And again, I think the way you analyze a going concern is the reserves and capital in place, as well as the earnings capacity, which is the function of the businesses that that institution is engaged in, and your ability to overcome and work through problems.

Senator **GRAHAM**. I see Dr. Eisenbeis wants to inject a comment on that. But if I could ask another question and maybe you could elaborate on that as well.

It seems to me that what you just described would be an appropriate strategy if you were dealing in a totally free market situation. But the issue that concerns us is that we're dealing with a socialized institution, i.e., deposit insurance, which is behind all these judgments. And one of our responsibilities is to try to protect the general public from having its insurance deposit fund placed excessively at risk.

So maybe the question is, just as the market quickly reacted and increased the cost of Chase Manhattan's borrowing from 9 percent to 13 percent in assessment of greater risk, are there a greater range of options that the Federal Government ought to have between doing nothing and hoping that it works out, or determination of the institutions?

Mr. **EISENBEIS**. Let me make a couple of observations on the point that was made, because I disagree with this approach which amounts to forbearance.

I think there is a danger of applying a new set of rules to institutions that operated under a different set of rules and say that if you applied those set of rules to those institutions, the results would have been different.

Let me give you an example.

A while ago, we lowered the speed limit from 65 miles an hour to 55 miles an hour on superhighways. We never said, if we lower those speed limits, all those people who were driving at 65 miles an hour will be suddenly breaking the law.

If we had lowered the speed limit and not told anybody, we could have caught a lot of speeders.

The point is if you change the rules of the game, lower the speed limit to 55 miles an hour, then people will drive on average closer to 55 miles an hour than they will when the speed limit is 65 miles an hour.

The problem that we face is that if institutions don't know what the rules are, they don't know what's going to happen when they get in trouble. I would guarantee you that if we had had the rule about closing institutions as the net worth goes to zero and if they knew that they were going to be closed when net worth went to zero, they would not have had the same amount of Third World debt in their portfolio. They would have hedged themselves differently.

You've got to worry about how people respond to a set of changed incentives and whether they know what the rules are.

That's why I think it's important to put in a set of capital policies coupled with early intervention. If we say well capitalized institutions with less supervision, less interference from the Government, if they have high levels of capital, and then as their capital levels start to decline, we increase the monitoring, we increase the kind of penalities—incentives and behavior will change. We should also give the regulatory authorities the authority to suspend dividend payments.

An institution should not make dividend payments when capital is eroded. That's just giving away a safety margin.

As institutions' net worth starts to decline, we need to increase the amount of sanctions at a point when they're still healthy and they have time to come back around.

Right now we have a set of policies such that we don't hassle institutions over these issues to any great extent until capital is gone. And that's the problem that we've got to get away from.

Senator **Graham**. Excuse me, Mr. Chairman.

The **Chairman**. Go ahead.

Senator **Graham**. Is that scenario that you just described a legal requirement of the regulators; that is, are they in a situation where they must wait until the institution is essentially in the morgue before they can act? Or is it a matter of their regulatory discretion, that they have determined to act in that manner and not utilize a range of earlier intervention strategies which are available to them?

Mr. **Eisenbeis**. There are two problems. If regulators determine that an institution has engaged in activities that constitute an unsafe and unsound process, they do have the authority to issue cease and desist orders and to stop those particular activities from taking place.

When they've gotten into difficulties is when the regulators seize an institution and the owners claim that it wasn't insolvent. At that point the matter goes into the courts; meanwhile, the assets start to dissipate.

There is a this bias on the part of the regulatory agencies to not get into these kinds of legal hassles, so they wait until an institution is really insolvent, then they avoid going into the courts. It is a constraint on regulatory behavior.

Senator **Graham**. And that gets to an issue that has concerned me during my time on this committee. And that is the tendency to merge the chartering function with the insurance-underwriting function.

A company may be somewhat away from insolvency when the Travelers Insurance Co. decides, we don't want to continue to provide insurance for this firm because we think that it's at a point where it may take risky decisions beyond that that we're prepared to accept.

Are the insuring agencies capable of implementing the kind of strategies that you have suggested? That is, saying to a bank, you can continue to have your charter, but you won't have any insurance if you pay dividends given your position?

Mr. **Eisenbeis**. Sure, they're able to do that. If a bank has a Federal charter, it is required by law to have insurance. So if insurance is revoked, that's tantamount to revoking the charter. At the State level, I don't believe there are any States that don't have insurance as a condition for remaining open having insurance.

For this reason revoking of insurance is tantamount to revoking the charter.

Senator **Graham**. But it goes to the point that you made, that revoking the charter gets into all kinds of due process and other property rights.

Mr. **Eisenbeis**. True.

Senator **Graham**. Nobody has a property right to insurance.

Mr. **Eisenbeis**. No, that's right.

Senator **Graham**. I don't have any, I can't force Prudential Insurance Co. to insure my life or insure my property.

Similarly, no bank has a property right in FDIC insurance.

Mr. **Eisenbeis**. I agree with that.

Senator **Graham**. So it seems to me that the insuring agencies have greater latitude to implement the sort of sophisticated tactics and strategies short of the institution being in insolvency, moreso than the chartering and regulatory agency.

Mr. **Eisenbeis**. They have that capability. There's no question about it.

Senator **Graham**. What is your assessment, and I would ask that to both of you, of how well the insuring agencies have exercised the range of discretion which is available to it?

Mr. **DeStefano**. The commercial banking side, as opposed to the thrift side?

Senator **Graham**. On either.

Mr. **DeStefano**. I think that they've done a pretty effective job to date. On an earlier point, this notion of waiting until insolvency, my recollection is that all the Texas banks were closed when they were still technically solvent. So the regulators didn't even wait until the last minute.

The nonperformers rose, and if you had marked those to market, it would have wiped out capital. So that, in effect, you can say they were insolvent, but as a matter of fact, I think the captial ratios were still very impressive until the day they were closed.

But that's just——

Mr. **Eisenbeis**. These institutions were economically insolvent. It's the economic insolvency and not book insolvency which is important.

Mr. **DeStefano**. Right. But the regulators did not wait for the bookkeeping to keep up. They'd just go in and they'd close the institutions. I think that, by and large, they have shown an astuteness and have appropriately closed commercial banks.

There's another vaster question, that when you have a problem in a major bank like Continental Illinois, what do you do?

Well, the fact is, they read the situation I think correctly, that they had to intervene vigorously and preserve the institution for the sake of overall financial stability.

However, that doesn't solve, then, the problem of overcapacity within the industry if everyone's going to be saved. But I think it's a real tough call. By and large, I think the regulators on the commercial banking side have behaved pretty responsibly, at least as I've observed their action.

The **Chairman**. Now, would you just yield at that point, because you've just made an argument for forbearance, a form of forbearance.

Mr. **DeStefano**. Of a kind.

The **Chairman**. No, I understand, of a kind in the Continental Illinois situation.

But Mr. Eisenbeis, would it be your view that even in the Continental Illinois situation, that you really ought to stay out of the forbearance business?

Are there situations where forbearance to preserve the system—if someone invokes that systemic argument—cases where forbearance, would be necessary, would be sound and prudent to undertake?

Mr. **Eisenbeis**. Most of the time, those forbearance arguments, as they relate to the so-called "too big to fail" argument, come about because people perceive there is a threat to the safety and soundness of the system.

The only way you can have that kind of a threat is if there's a run to currency. And we just don't have runs to currency any more.

It's within the capacity of the Federal Reserve, as the monetary authority, to offset those kinds of problems.

So I think that once you start going down this road, you end up in situations where "too big to fail" becomes inevitable, and that's not in the country's long-run interest. So the answer is no.

The **Chairman**. So you're saying the answer is no. And that if Continental Illinois is going down, you let them go down. And if there's a run on cash, you get the Brinks truck up there until you have as much cash as you need. You give people their money back. They understand that there's no reason to go to some other bank and draw their money out there.

Mr. **Eisenbeis**. That's right.

The **Chairman**. So that's your answer. If I could just ask one more related question Senator Graham, it would be this.

I detected when Bill Seidman was here the other day—I don't know, Senator Graham, if you were in the room at the precise moment when, in a response to Senator Bond, he floated the concept that maybe some other approach ought to be used to keep some of these institutions open rather than bringing the hammer down now and sending a lot of assets into the RTC and having to come up with the cash to do the closings.

No one was expecting such a response and it set off some real shockwaves around here. No matter what words you use, it in effect becomes forbearance.

We didn't pursue it at great length but he may have been saying that you may have a systemic problem that's grown up here. It isn't the run-to-cash problem that you cite. But it may well be that we've got too many institutions in the tank at once. Maybe we are overtaxing the system to manage tanked institutions and the mounting pile of repossessed assets. Maybe the problem has begun to feed on itself. Maybe the problem has grown to such a dimension that it has become systemic.

I don't know how he would respond if he were here, if he'd put it in such words or even if he'd want to talk about it at all right at the moment.

Maybe he was saying even against his own instinct, which is exactly the same as yours, no more forbearance, he may now feel that we as a country are getting cornered with a set of circumstances of such dimension that may require something like the Continental Illinois workout. That, lousy as that answer might seem, it might be better than all the other choices facing us.

Now, that's doing a lot of trying to read between the lines, but that's——

Mr. EISENBEIS. I think the best way to look at this is we know we have a problem in the real estate area, and these problems are causing some institutions to become economically insolvent.

We can finance the holdings of their assets either by taking them into the RTC and issuing Government debt, and using that to pay off the different—sell the assets, get them out into the private market—or we can finance them by allowing economically insolvent institutions to keep operating.

The end result is the same. In the one case, we're going to finance the operations, the holding of those assets with Government debt. And in the other case, we're going to allow the financing of those assets to take place with the issuance of insured deposits.

In either case, it's still, because of the deposit insurance system that we have, the liability of the U.S. Government. We're just going to finance the holding of those assets in one way or another.

I think experience shows that forbearance, and particularly allowing insolvent institutions to operate, accelerates the losses because there's not the private incentives in place to manage those assets.

The CHAIRMAN. His answer to that would be that if you have a firm that's not under water, that's struggling and is marginal, that they should continue to be the manager. And as much as you might want a better manager, you might not be able to put somebody else in that's going to do a better job, when you've got dozens and hundreds of these problems to deal with at once.

Mr. **Eisenbeis**. I think that there's a clear distinction whether the institution is truly economically insolvent or whether it just has low levels of capital.

If it has low levels of capital, then you're in the mode, I believe, where you've got to be monitoring it. It's still being run by the others, but you've got to monitor it.

The **Chairman**. Right.

Mr. **Eisenbeis**. And if it gets to the critical level, let's deal with it before it goes negative and involves a drain on the taxpayers' funds.

The **Chairman**. Yes, I think that we would all agree with that. Let me yield back, and I thank you.

Senator **Graham**. I guess the question is the quote, let's deal with it. What does that mean?

I have had the same reaction to the word forbearance and what it connotes and what it has meant in the thrift industry.

But as the chairman was saying, the alternatives aren't that great, either. One of the problems that we've seen in the thrift industry is when the current management is taken out, and I'm assuming it was not current management that was involved in fradulent or criminal activities, just managed the bank into severe financial problems all the way to insolvency. But when that management is replaced by a Government-designated manager, several things seem to be happening.

No. 1 there is a rather significant run of deposits, that institutions' deposit base goes down.

No. 2 is there seems to be a pattern that in order to reverse that, that those institutions end up paying the highest CD rates in the community.

No. 3 people who deal with the institution have a hard time getting decisions made on just sort of the day-to-day, garden variety relationships that exist between a lender and their creditor.

I'm wondering if there isn't some more sophisticated relationship that could begin to occur at a point prior to insolvency that would not necessitate the managerial changes that are now occurring.

I want to just sit down and talk with our chairman about an experience that he knows probably as well as anybody, and that is the Chrysler situation. What are some lessons that we might learn from that experience that would be relevant to the issue of how the Government deals with financial institutions?

Mr. **Eisenbeis**. I think you've made my case as to why we don't want to keep economically insolvent institutions afloat and why you don't want to finance the holding of those assets in the existing institutions.

We have suggested in our Shadow Committee proposals that we should have a series of capital trenches. As an institution starts to move down through those capital trenches, the kinds of restrictions and penalties that institutions face become more severe.

They should also have to pay for monitoring, which becomes a form of risk-based premiums. The amount of labor involved in monitoring the institution should increase as risk increases.

When capital reaches some admittedly, arbitrarily low, but positive level we force that institution to be recapitalized. Existing owners either have to put more of their money into that institution or they have to make the decision it is not a going concern. At which point it goes into liquidation. Any proceeds left over should be distributed back to the owners, so we've not confiscated property and we've avoided the problem of having a negative net worth situation.

That's one of the ways you get exit from the industry in a controlled, managed way. The market makes the decision ultimately as to whether these firms are net present value projects.

Mr. **DeStefano**. Except that in terms of application, you're thrown back upon—economic solvency really depends upon the value of the assets. At what point do you mark those to market and what are the true values there? Do you take the most conservative liquidation approach? Do you give credit for the possible recoverability of values there?

All I'm suggesting is I think the approach, while going forward insofar as it's building in disincentives for risk-taking, is attractive from a credit point of view. Practical application for the thousands of banks out there today, I think could probably—I think it's more difficult than maybe some of us have thought that it is.

Mr. **Eisenbeis**. The point, however, is that the discussions, concerns, and all of these questions about what the appropriate value of the assets are in the institution should take place before equity has declined to zero rather than after equity has declined to zero.

I realize that there are difficulties in establishing the appropriate values, but let's get those difficulties out on the table ahead of time in anticipation again of problems rather than reacting after the fact.

The key is just hedging our bets.

The **Chairman**. Gentlemen, I appreciate very much your coming and your observations today. I'm going to be giving you both some questions for the record, if I may, from colleagues who had to go and do other things and could not remain.

But it's been very helpful to us and I appreciate the thought and the time and the directness.

Mr. **Eisenbeis**. Thank you, Mr. Chairman.

The **Chairman**. The committee stands in recess.

[Whereupon, at 12:46 p.m., the hearing was recessed.]

[Response to written questions and additional material supplied for the record follow:]

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

CHARLES A. BOWSHER

GAO
United States
General Accounting Office
Washington, D.C. 20548

Accounting and Financial
Management Division

1. The Resolution Trust Corporation has had to ask for working capital to allow it to take over assets from failed thrifts that it will sell later. You say that the BIF may well face a cash flow problem when it reimburses acquirers of failed banks for troubled assets they choose to return to the FDIC. What would be the best way to handle this problem, in your estimation? Should the FDIC raise bank premiums or borrow from the Treasury?

As we stated in testimony before this Committee and in our report on the results of our 1989 audit of the Bank Insurance Fund, we believe a premium increase is needed immediately to begin to restore the cash and equity balances of the Fund to levels that will enable it to deal effectively and timely with problem institutions. In our opinion, raising the premiums banks pay for deposit insurance is a necessary first step in shoring up the Fund.

We would support the Administration's recent proposal to enact legislation which, like your bill, removes the restraints of FIRREA and allows FDIC to raise premiums to the level they deem necessary to meet their needs. In addition, the Administration's proposal enables FDIC to borrow directly from the Federal Financing Bank (FFB). We believe FDIC should fund its operations through premium assessments to the extent it believes the industry could absorb such assessments. Furthermore, to ensure that FDIC acts promptly and decisively in resolving troubled banks, we believe FDIC should have the ability to borrow from the FFB for short-term working capital needs. The use of FFB borrowings should provide less expensive financing for FDIC than the issuance of FDIC notes to purchase assets of insolvent institutions. We would stress, however, that in considering this alternative the Committee should ensure that any borrowings from FFB to cover working capital needs must be fully collateralized to avoid potential future repayment difficulties.

2. Chairman Seidman noted in his September 10 testimony before the Committee that financial institutions lose franchise value rapidly after being taken over by the government, leading to the suggestion that it might be cheaper for the government to defer takeover on well-managed but undercapitalized institutions. What is your opinion of this approach, given the

extensive experience that we have now had with forbearance prior to 1989 and with the massive takeovers from 1989 to date?

Our work on both banks and savings and loans indicates that forbearance is not a path this nation can afford. Experience with problem institutions in the past has demonstrated that to delay the closing of an undercapitalized institution, even a well-managed one, more often than not has resulted in the federal system of deposit insurance incurring larger losses than would have been incurred had the institution been closed promptly.

The Bank Insurance Fund's cash and capital resources are insufficient to deal decisively with the exposures it faces. To that end, we believe that Congress and the Administration should focus their efforts on strengthening the Fund through increased premium assessments and capital requirements, stronger regulatory supervision, and accounting, auditing, management, and reporting reforms. Recent proposals by this Committee and others to increase premiums and to provide funding for working capital needs are an encouraging and necessary first step toward restoring the health and stability of the Bank Insurance Fund. Forbearance, as has been proven by recent history, is a step in the wrong direction.

3. Raising capital is doubled-edged sword. On one hand, higher capital increases safety and soundness and adds an additional layer of protection for the deposit insurance fund. However, if capital requirements are raised too high, institutions become inefficient. According to a recently released CRS study, higher capital levels may have a deleterious effect on the ability of our financial institutions to compete on the international level. Do you agree that capital levels could be raised too much? How and where would you draw the line?

We agree in principle that capital levels could be increased too much, but at this time the levels are too low for many banks relative to the risks that those banks pose to creditors and the FDIC. We do not have an exact figure to recommend, but believe the capital requirements should be set by the regulators at higher levels to better protect FDIC from loss. Higher capital levels increase the ability of financial institutions to absorb losses and provide regulators an improved margin of safety or early warning to work with troubled institutions before assistance is needed and losses accrue to the insurance funds.

It may not be easy for some banks to increase their capital ratio. However, we believe that increasing the minimum risk based capital requirement above the current 8 percent minimum level could be gradually phased in and banks should be allowed to meet a part of the increased capital requirement through subordinated debt. Subordinated debt provides additional market discipline because the costs of such debt will vary with investor's perceptions of bank risk and at the same time is attractive to the banks when compared with equity capital because the interest expenses are tax deductible. Not all banks will be able to operate efficiently with a higher capital requirement and the consolidation of the industry that has been occurring since the middle of the 1980s will continue.

Higher capital requirements on U.S. Banks may put some U.S. banks at a competitive disadvantage to some foreign banks in the short term, although tax and accounting differences between countries makes comparisons difficult. However, there are currently many successful banks that already have capital above regulatory minimums. Furthermore, well capitalized banks are in the best position to absorb temporary losses and expand their business activities to meet the changing financial environment.

4. The FDIC Quarterly Banking Profile, released recently, shows the banking industry experiencing lower net income, as compared to last year, but paying out higher dividends. Should banks with no equity capital be allowed to pay dividends? Should unprofitable banks (and thrifts) be allowed to pay dividends? Should unprofitable banks be allowed to increase their dividends?

Banks that are equity insolvent or unprofitable should not be allowed to pay dividends to their shareholders. We believe supervision in this area should be tightened up because our evidence has shown that some problem banks have paid dividends even though their supervisors suggested they stop dividend payments.

It has been argued that banks will not be able to raise capital if they do not pay dividends even when they are unprofitable. However, we believe stockholders and bondholders longer-term financial concerns should be paramount to periodic dividend payments. Stockholders should be more concerned about the value of the bank as a going concern (and therefore the value of their stock or investment) than dividend payments of substantially lesser value. Similarly, bondholders' primary interest is the ability of the bank to service its debt. Bondholders should be very concerned in that regard if a bank that is equity insolvent or unprofitable is paying dividends to its shareholders.

Response of Michael DeStefano to the question of Senator Donald Riegle following the September 12, 1990, hearing on the condition of the banking industry.

A.1 The Comptroller General in his September 11 testimony expressed concern over the poor quality of "Call Report" data--the data that is released to the public. Do you use the Call Report data? Is it accurate, in your experience? Is it made available in a timely fashion? Are there other data series that you would like to see--series that would help your assessments of banks' condition that are not currently available?

A.1 Standard & Poor's bank analysts make heavy use of call report data in their analysis of banks. Generally speaking, the data provided in the call reports is accurate, in the sense that it reflects the numbers as reported by the bank. However, in those areas of the report relating to asset quality, the banks have considerable discretion in how they classify assets, and this discretion can present a distorted view of the health of the reporting institution. While the reports are filed with the regulatory authorities in a timely manner (about 30 days after the end of the quarter) those (the general public) who must rely upon the data providing services for access to the reports must normally wait about 90 days subsequent to the end of the quarter before seeing the reports, and a lot can change in that time.

It would be helpful if the reports went to a format consistent with the risk adjusted capital standards, so that it would be easy to calculate this important ratio. In addition, and more substantially, it would be good if the reports required greater breakdown of the loan portfolio so that it would be possible to monitor growth in particular categories of loans. For example, instead of one real estate loan category, a breakdown by underwriting standards and/or by property type would shed greater light on the risk profile of the portfolio. Similarly, a breakdown of loans to lesser developed countries would have been helpful in the days when exposure to these loans was of great concern. In general, the more detail on the asset portfolio the better in order to facilitate an evaluation of the bank's asset risk profile.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE FROM

ROBERT EISENBEIS

Q.1. The FDIC Quarterly Banking Profile, released recently, shows the banking industry experiencing lower profits and having a smaller stock of reserves against troubled loans, as compared t last year. Yet the industry is paying higher dividends. Should banks that fail to meet their capital standards be allowed to pay dividends? Should unprofitable banks (and thrifts) be allowed to pay dividends? Should unprofitable banks be allowed to increase their dividends?

A.1. In line with the policy recommendations made by the Shadow Financial Regulatory Committee, which I am a member, we proposed that stricter capital standards be imposed and that 4 Tranches for assessing capital adequacy be established. Institutions in the highest Tranche (with market value of equity above 10%) would be subject to only normal supervision. For institutions with this level of soundness, they would be permitted to pay dividends, regardless of whether they were making losses or not. However, for institutions in the next lowest Tranche (equity between 9.9-6%), the regulatory authorities would have the authority to suspend dividend payments, and we would presume that they would. Institutions would be encouraged to work immediately to rebuild their capital positions, and I would hope that internal souces would be used rather than distributing equity to shareholders in the form of dividends. When an institution's equity fell below 6% then dividend payments as well as payments of interest on subordinated debt would be suspended, and interst payments on deposits could also be limited. It would seem reasonable to require institutions to build capital using all available options, and that they should be precluded from paying any dividends.

UNC
Business School
AT CHAPEL HILL

Robert A. Eisenbeis
Wachovia Professor of Banking

CONGRESSIONAL BUDGET OFFICE
U.S. Congress
Washington, DC 20515

Robert D. Reischauer
Director

November 19, 1990

MEMORANDUM

To: Lory Breneman
Chief Clerk
Senate Committee on Banking, Housing, and Urban Affairs

From: Stanley L. Greigg
Director
Office of Intergovernmental Relations

Back in September, Dr. Reischauer testified before the Committee on the condition of the banking industry and bank insurance fund. The transcript has long been returned; however, two questions were submitted to which we are now providing the response. I would hope this will close out all of the materials related to the September 12th hearing.

Enclosure

Q.1:
Bert Ely says that the Bank Insurance Fund (BIF) is a fiction. It is merely a line on the nation's budget. BIF income goes to the Treasury and BIF expenditure draws on the Treasury. Is Mr. Ely correct? If so what difference should this make to the way we treat the fund? Do we still need to raise bank insurance premiums, for example?

A.1:
The Treasury maintains BIF, which is a public enterprise revolving fund, just as it maintains all federal government funds and accounts. BIF income goes to the Treasury and is credited to the fund, and BIF expenditures are recorded by the Treasury as a deduction from the fund.

Thus, the fund is an accounting mechanism for measuring how spending for a specific purpose--protecting insured bank depositors--compares with the income intended to finance its activities. The fund also serves as a control mechanism, because legislative action is necessary if the accumulated assets and borrowing authority of the fund are insufficient to cover its obligations. The fund balance, however, is not a measure of the total resources available for bank deposit insurance, because the "full faith and credit" of the U.S. government stands behind the deposits that the fund insures. The fund accounting also does not fully measure the potential liabilities of the government, because it records only net losses that are either imminent or already incurred.

Whether the Congress should raise bank premiums depends on one's view of how the Federal Deposit Insurance Corporation's costs for bank insurance activities should be allocated and whether the fund is or should be self-sustaining. On the one hand, if one believes that the providers and users of depository services should pay for these costs and that the fund should be completely self-sustaining, it is appropriate to raise bank premiums to a level deemed sufficient to cover BIF's liabilities. (Because the effect of higher premiums on institution failure rates is not clearly known, increasing premiums should be done cautiously.) On the other hand, if one believes general taxpayer support is warranted, premium levels need not be as high.

In theory, it is not essential that BIF be completely self-sustaining. Society as a whole, and thus taxpayers in general, benefit from the added stability provided by deposit insurance. Thus, it is not necessarily inappropriate for the general government budget to partially finance deposit insurance, particularly if there is a financial panic (or systemic financial crisis) or a structural change in the depository institutions industry such as the consolidation of institutions that has taken place recently. In either of these cases, the taxpayer can be the insurer of last resort. If funding from both the BIF account and the general government budget were desired or necessary, it could still be advantageous to maintain the BIF as a separate identifiable fund in order to monitor the contribution from each source and to measure the taxpayer subsidy associated with this government function.

Q.2:
Should banks that fail to meet their capital standards be allowed to pay dividends? Should unprofitable banks (and thrifts) be allowed to pay dividends? Should unprofitable banks be allowed to increase their dividends?

A.2:
Bank profits contribute to the capital stock of depository institutions, and dividends are paid from the capital of the institution. If a depository does not have a sufficient level of capital to satisfy regulatory requirements, then it would be inadvisable to permit the payment of dividends, because that would only cause the level of capital to deteriorate further. It is possible, however, that an institution's ability to raise new capital might hinge, to some extent, on its perceived ability to pay dividends.

Dividends are related to profitability only in as much as current profits contribute to capital. Therefore, a well-capitalized depository that is unprofitable for one quarter might well be permitted to continue to pay dividends--but only so long as such dividend payments would not reduce capital to a level below the requirements. A case might be made that restrictions on dividend payments should not be imposed so long as a depository is in compliance with capital requirements; however, as added protection to the taxpayers, it might be advisable to prevent an unprofitable depository from increasing its rate of dividend payment.

The Future for Mortgage Lending:

The Texas Experience

By

Robert A. Eisenbeis
University of North Carolina at Chapel Hill

and

Paul M. Horvitz
University of Houston

I. Introduction

Since the 1930's, savings and loans have been the principal source of housing finance. They have devoted the major part of their assets to home mortgages or other mortgage-related assets. This business has generally been profitable, though the thrift industry suffered losses during periods of high interest rates, such as 1966, 1974 and 1979. Despite the occasional credit crunches, failures of thrifts were relatively rare events until the 1980's.

The 1980's have been a true watershed for both banks and thrifts. Failures have become common place, even among the largest firms in the industry.[1] The Federal Savings and Loan Insurance Fund became economically insolvent and was propped up twice, first in 1987 and then again in 1989, at a cost to the U.S. taxpayer of over $100 billion. The recently passed Financial Institutions Regulatory Reform and Enforcement Act (FIRREA) of 1989 responded to this crisis by reforming the federal deposit insurance funds for both banks and thrifts, backed these funds with the full faith and credit of the U.S. government, and made substantial changes in the regulation of savings and loan associations.

These changed ground rules for operating savings and loans have led some to question the continued viability of the thrift industry. The franchise value of a savings and loan charter has been eroded by several aspects of the regulatory changes made by FIRREA: increased deposit insurance premiums, a stiffened "qualified thrift lender" (QTL) test, and the confiscation of some of the capital of the Federal Home Loan Banks (with a consequent reduction in the value of savings and loan holdings of Federal Home Loan Bank stock). Nearly all observers expect a shrinkage of the savings and loan industry, due to continued failures, conversions to commercial bank charters, and acquisitions by commercial banks. This has raised concern about the future of housing finance and where the institutional support for housing will come from.

The actions by the Administration and Congress to make good on the government's deposit insurance guarantee, and to assure that such losses do not recur, raise a serious question about the possible unintended effects of changes in regulation. The changes in the regulatory framework for thrifts were designed to prevent large losses to the insurance agency. Since recent experience suggests that home mortgage lending is safer than the other activities engaged in by some thrift institutions, FIRREA sought to promote safety, as well as to maintain the availability of housing finance, by stiffening the QTL test--raising the proportion of total assets that thrifts must keep in housing-related assets. It is well-known that government regulation often has unintended effects, and sometimes has effects opposite those intended. There are considerable doubts, for example, that forced specialization of depository institutions is consistent with their long-run viability. Ironically, this focus on asset risk as the means to assure safety and soundness ignores the original source of the S&L problem, namely, the forced asset and liability mismatch which made them vulnerable to interest rate risk. Indeed, asset diversification was proposed early on by the Hunt Commission in 1971 as the means to reduce this exposure.

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[1] American Savings, once the largest S&L in the country failed in 1988, Continental Illinois National Bank, once the largest commercial lender in the country and the 9th largest bank, failed in 1984, and other money center banks, such as Manufacturers Hanover and Bank of America have been in difficulty at one time or another.

In this paper we look beyond the immediate problems affecting S&Ls. We address the question of whether there is a future for specialized real estate lenders as an important source of housing funds, and whether, if thrift institutions do decline in importance, commercial banks can be expected to become more important as sources of mortgage financing. Eisenbeis and Kwast (1989) have argued that properly structured and managed, commercial banks that voluntarily specialize in such lending can be quite viable.

The Eisenbeis and Kwast results are comforting, but most of the banks covered by their work operated in generally benign real estate markets. There is a legitimate question of how well such institutions might hold up under extreme pressures. We look for clues in Texas, where the problems of real estate lenders have been the greatest, and attempt to assess the prospects for institutions specializing in real estate lending. We follow the approach of Eisenbeis and Kwast(1981, 1989) and examine the performance of a group of commercial banks in Texas which chose voluntarily to specialize in real estate lending during the 1978-1987 period. We will examine how these institutions performed when compared with regular commercial banks in both Texas and the rest of the nation. If there is a future for a specialized housing lending industry, then the harshest environment, and perhaps most interesting place to look for survivors and how they did it is in the ashes of the Texas collapse. In the remainder of this paper we first discuss the situation in Texas, how it evolved, and what happened to its thrifts. After examining the causes of the problems of banks and thrifts in Texas, we then look at the performance of those banks that chose to specialize in housing lending to see how they fared.

II. The Situation in Texas

In order better to interpret the evidence on performance of specialized lenders, it is first useful to dissect the causes of the Texas situation. Some of the problems for Texas institutions are common to thrifts throughout the country, namely macro economic factors, such as high and volatile interest rates. Other factors are more Texas specific, such as the existence of a speculative environment, liberal powers for state chartered thrifts, etc. The relative importance of these latter causes in explaining the collapse in Texas, should serve as beacons or red flags to the regulators as they go about their business of reforming the supervision of insured depository institutions. We first examine the macro factors and how they impacted Texas institutions. Then we turn to the Texas specific factors.

A. National and International Economic Factors

There are several national and international economic effects which had significant effects on the viability of thrifts in the state of Texas. This includes not only oil price shocks and inflation, but also U.S. tax policy and several other important considerations.

1. Oil

The story of Texas thrifts is inexorably linked to the price of oil. The prosperity of the Texas economy as a world center for oil was fueled in the early 1970's by OPEC driven changes in oil prices. While dependence of the economy on oil is a distinctly Texas attribute (also important in Louisiana and Oklahoma), changes in oil prices were externally driven and were affected by OPEC oil policy. The roller coaster ride of the Texas economy which saw huge runups and then falls in housing and real estate values was driven in large part by the cyclical variation in the price of oil.

By 1973 oil had reached the cartel price of $15 per barrel, but it skyrocketed to $40 per barrel following the second oil shock in 1979. Prices declined thereafter to $35 dollars in 1981, fell further in 1985 to $26.50 and crashed to under $10 in 1986. The early price increases spawned an optimism that the spiral would not end. After all, oil was a limited resource which was being used at alarming rates. The optimism that came with the sudden wealth created by the rise in oil prices induced further investments in rigs and exploration for more reserves. Proven reserves in the ground also served as collateral for oil-related and non oil related credits. Loans backed by sound collateral when oil was at $20 per barrel became at risk with 1986 prices at less than $10 per barrel.

While employment in Texas did fluctuate with oil prices, the effects were not usually long lived. For example, during the first price decline in 1982, nonagricultural jobs declined by about 200 thousand from peak 1982 levels to the 1983 trough, but recovered by the end of 1983. Total nonagricultural jobs peaked in 1986, declined by about 300 thousand jobs, and then reached a new peak in 1989, exceeding pre-collapse levels.[2] Furthermore, other measures of the real Texas economy also exceeded the previous peak. Retail sales for example totalled $125 billion in 1988, exceeding the 1985 peak.

The Texas employment pattern roughly parallels the experience of other local economies heavily dependent upon one or a very few primary industries, such as autos in Michigan, steel in Pennsylvania, coal in West Virginia, aircraft and forest products in the Northwest, or textiles in New England. Declines in those industries at one time or another had major effects on the local economy, but did not result in bank or thrift failures. The explanation for the magnitude of the Texas bank and thrift collapse has to be found in other factors besides just the problems of the energy business.

2. Agricultural Problems

Texas also had a significant agricultural economy, third only to California and Iowa. Diversification benefits were not realized however, since all of the major Texas agricultural commodities - cotton, corn, wheat and cattle-hit new lows for the decade in 1986 although these prices rebounded sharply in 1987. Again, Texas was not all that different from other agricultural states which experienced problems due to drought and price declines in the mid-1980's. Such states as Kansas and Iowa suffered a large number of failures of relatively small banks but did not experience a collapse of their banking systems.

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[2] Total nonagricultural jobs peaked in the state at 6.7 million in early 1986, dropped slightly in 1987 and then exceeded the 1986 level by 100 thousand jobs.

3. Federal Tax Policy

Federal Tax policy was also an important cause of over- extensions in the real estate area. The Economic Recovery Tax Act of 1981 nearly doubled the allowable depreciation of real estate investments during the first 5 years of the project. As a result, many projects were undertaken solely because of their tax consequences and not because of real project values. Many projects were clearly uneconomic from their conception in the absence of the tax benefits. The Tax Reform Act of 1986 drastically reduced the allowable write-offs during the 5 year period from 40% to 18%, and in combination with other related changes, significantly reduced the tax incentives for real estate investments.

4. Supervisory Shortcomings

If the Federal Home Loan Bank Board had handled its supervisory responsibilities properly, the losses suffered by the FSLIC would have been much less. The Reagan Administration seemed to confuse regulation (which it was dedicated to reduce the burden of on American Business) with supervision. It refused to allow the Bank Board to add to its examination and supervision staff at the time that many economically insolvent thrifts were facing strong incentives to take great risks. Deposit insurance allowed these weak institutions to attract additional deposits with little difficulty. Lack of resources also forced the FSLIC to allow insolvent institutions to continue in operation long after they should have been closed. This factor explains the large losses suffered by the FSLIC in Texas thrift failures. In contrast, the FDIC, which was also confronted with a large number of bank failures in Texas, had smaller dollar losses.

D. Texas-Specific Problems

Key aspects of the Texas economy and culture must be kept in mind in assessing the prospects for thrifts or specialized lenders.

1. Lack of Diversification

The Texas economy is not well-diversified now and was even less so through the early 1980's. The dependence on oil and oil-related business was substantial. The loan portfolios of the major banks were even more dependent on the energy sector than the economy as a whole. In these circumstances, a decline in oil during the 1980's would have a significant impact on bank expenses and revenues.

The Texas economy, and particularly Texas real estate, had enjoyed a long period of prosperity. While Texas had historically experience dramatic cycles in oil prices, similar price fluctuation had not taken place in real estate in major cities. It's possible that this long history of price increases in real estate led lenders to be unduly optimistic in their approach to real estate lending.

This question is even more relevant to S&Ls which were not lenders to the oil industry, and had little in the way of direct losses due to the first oil price shock. Their problem was real estate lending, which did not appear to be a bank problem until a little later. It is obvious in retrospect, that the real estate projects being financed by S&Ls in Texas were based, directly or indirectly, upon the energy business. It should have been clear, for example, that housing development loans in Midland could only be viable if there were employment increases in the oil business. Similarly, a strip shopping center in Houston was dependent upon the viability of the Houston economy, and this, in turn, was dependent upon the oil patch.

Also several of the large Texas banks had traditionally been active in construction lending and other non-residential real estate lending. As compared with other real estate lending problems for banks, the Texas banks concentrated their lending in local markets where they supposedly had an information advantage. This contrasts with the out-of-area lending that had been associated, for example, with the REIT problems in the early 1970's. It was easy to criticize bank managements that took losses in REIT lending to finance developments in Florida, Atlanta or Tennessee, but out-of-area lending was not the source of Texas real estate lending losses.

2. Texas Financial Structure

One rather unique characteristics of Texas banking structure which may have tended to make its institutions more vulnerable during periods of stress was its long tradition of unit banking. This resulted in a large number of small, locally oriented and not well diversified institutions, and increased the likelihood of failures if the state's banks came under stress.

3. Speculative Attitude

A third consideration is cultural and less susceptible to quantitative measurement. There appears to be a prevalent Texas attitude that when things are going bad, the appropriate response is to double the bet rather than to cut one's losses. There were ample opportunities for Texas banks to accept the fact that the decline in the oil business meant significant losses and to halt to their growth. But most could not apparently accept that economic reality, and instead attempted to continue to grow by shifting into the other major Texas growth opportunity, real estate. This general willingness of Texas managements to take additional risks as their situation worsened was exacerbated by incentive problems in the flat rate deposit insurance system which enabled Texas institutions - both banks and thrifts - to fund their explosive growth with federally insured deposits at rates far below what they would have had to pay had the market been exposed to the losses inherent in the assets.

4. Fraud

Many discussions of the S&L industry emphasize the role of fraud. Because fraud was indeed present in many failed institutions, both S&Ls and banks, does not mean that fraud caused the failure. A recent study of FLSIC's 1988 experience in handing 205 failure concluded that not more than 10% of FSLIC's cost in those cases could be attributed to fraud.[3] In many instances when fraud was present, it occurred after the fact. That is, when it was clear to owners that the institution was doomed to fail, some fraudulent transactions were undertaken by less scrupulous owners and managers to extract sound assets out of the institution. Additionally, what some have tended to call fraudulent transactions were really insider abuses when developer/owners used the institution's resources to finance their own transactions for personal gain.

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[3] This was reported in a speech by James Barth, Chief Economist of the Office of Thrift Supervision before a U.S. League of Savings Institution's Conference, August 22, 1989. Barth indicated that of the $32 billion in cost to FSLIC represented by the 205 S&Ls, no more than $3 billion could be attributed to fraud. He noted that "Fraud and insider abuse exacerbated the problem but it's wrong to say that fraud was rampant."

5. Liberalized Powers

Nationally, the majority of savings institutions were organized as mutuals, but in Texas stock institutions were more prevalent. Until recently, stock institutions could not obtain a federal charter, thus most Texas thrifts were state-chartered, stock-holder-owned institutions. This structural difference was not significant during the 1960's and 1970's, but became important in the 1980's. As the deregulation of deposit interest rates resulted in increased competition for funds and put extreme pressure on spreads, Texas thrifts turned to more risky assets in an attempt to recoup their losses. This was much easier for Texas thrifts which had substantially more liberal asset powers than federally chartered institutions. During that time there were no limits on the percentage of assets used for loans secured by first liens on commercial real estate, raw land, or personal property (up to 100% of appraised value). Up to 10% of assets could be invested in service corporations which could then borrow and make direct real estate investments. Strunk and Case(1988) cite Texas, together with California, Arizona and Florida as the most liberal laws for state chartered thrifts.

C. Conclusions About Causes of Texas Failures

The general impression that one gets when looking at the experience of the Texas institutions is that it is hard to single out any one factor as the cause of the Texas collapse. But taken together several factors become important. First, the decline in the energy and real estate sectors probably would have led to significant losses, no matter how prudently the institutions were managed. But it's not clear that the economic decline would have resulted in widespread failures, if these institutions had been more diversified. It is an important question whether better diversification could have been expected. Certainly branching restrictions made such diversification more difficult and costly. But it appears that Texas banks were not concerned about their concentrations in energy loans, which were not diversified from price risk.

Second, it is clear that the real estate decline was crucial to the severity of the failure problem. In the absence of the real estate collapse, it is likely that the problems of the energy industry would have had no more effect on bank failures in Texas than the problems of textile industry in the 1950's did in New England. It might also be noted that the real estate collapse was not totally exogenous, as many Texas bankers would like to believe. There is no doubt that the extent of the overbuilding in Texas was fueled by the efforts of lenders to make real estate loans.

This review makes clear that the Texas economy of the 1980's was a most unfavorable one in which to be a real estate lender. While savings and loans were constrained by regulation to focus on real estate lending, this was not true of commercial banks. In view of the magnitude of the real estate collapse, we would expect those banks that chose to emphasize real estate lending during this period to fare much worse than more diversified banks. If that is not the case, however, then we have evidence that commercial banks may be able to fill any gap in housing finance left by the decline of the thrift industry.

III. The Texas Real Estate Banks

In this section we investigate further the prospects for institutions specializing in real estate lending in Texas and seek to determine whether tho problems in Texas were unique to that state or are potentially symptomatic of the nation as a whole. We follow Eisenbeis and Kwast(1989) who examined the performance of a national sample of commercial banks that voluntarily chose to specialize in real estate lending over the 1978 - 1987 period. To be included as a real estate specialized institution (REB), a bank had to have held 40 percent of its assets in real estate loans in a given year. Eisenbeis and Kwast) found that their specialized institutions performed quite well over the period, even without the subsidies for being specialized real estate lenders. Additionally, real estate banks did not appear to be more risky than regular commercial banks. In fact, when they looked at a sub-sample of longer term real estate banks, these banks appeared not only to be more profitable than regular commercial banks but also significantly less risky.[4] For purposes of looking at the prospects for real estate specializing banks in Texas, we look at the sample of those Texas banks that held at least 40% of their assets in real estate loans in any one of the sample years 1978-1987. These are compared with regular Texas commercial banks as well as with the real estate banks and regular commercial banks examined by Eisenbeis and Kwast(1989). Table 1 shows the distribution of the number of real estate and regular commercial banks in Texas. Regular commercial banks increased steadily in number over the sample period, peaking in 1986. Thereafter, reflecting the general problems in the economy they declined in number in 1987 (and in 1988), falling below their 1978 level. In contrast, there were not a significant number of Texas banks specializing in real estate lending until 1983, which corresponds to the year in which real estate banks nationally reached their lowest number and then began to increase. This increase was extremely significant in Texas where the number began to increase as the real estate problems began to appear.

Table 2 compares the profitability of these institutions with real estate and regular commercial banks nationally as well as with regular commercial banks in Texas. Unlike the results obtained by Eisenbeis and Kwast, the Texas REBs performed somewhat worse than either other real estate banks nationally or commercial banks. Earnings became negative both for the Texas REBs and for regular commercial banks as well. This suggests that the poor performance of the Texas banks was either due to unique attributes of these Texas institutions or to the Texas economy. Further inspection of the income results suggest that much of the poor performance was due to a few institutions which had extremely poor performance. We screened the real estate banks and eliminated those for which the absolute value of their ROA exceed twice their capital ratio. When earnings were negative, the REBs that were screened out by this criteria were economically insolvent by a factor of two, and clearly should have been closed and not in the sample. If the screened REBs had positive earnings of more than 200% of their equity in one year, this is an indication of an extreme structural change or an unrealistically high performance that could not be expected to be maintained. Table 1B shows that this screen does not reduce the sample sizes significantly. In Table 2B the screened sample of Texas real estate banks appeared to fare not much worse, until 1986, than the national REB sample; the regular Texas commercial banks tended to outperform the national sample. To eliminate to potentially misleading influence of the outlier banks, the remaining analysis uses these "screened" samples of Texas banks.

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[4] Longer term specialized institutions were those that were in the real estate bank sample for five or more years.

Table 3 examines the income information in more detail by breaking down the expense ratios into their component parts. Looking at the first column which contains the ratio of operating expense to operating income, a proxy for efficiency, both the Texas commercial and REBS compare quite favorably. Until 1987, both sets of banks had more favorable expense ratios than either the national commercial or REB samples. Only in 1987 were the Texas REBs less efficient than the national REBS. The remaining three tables, however, show that there are in fact greater differences than the efficiency ratios might imply. For example, the Texas banks appear to have had higher costs of funds beginning especially about 1983 than did the national sample banks. Whether this was due to the bidding up of fund rates by troubled thrifts is open to speculation at this point. To compensate for these higher interest expenses, both groups of Texas banks compensated partially by having lower non-interest operating expenses. It is in the area of loan loss provisions, however, that the problems in the Texas banks show up. Until 1986, the Texas REBs had even lower loan loss provisions than did the national REBs, which was the area that Eisenbeis and Kwast found these banks to have a comparative advantage. Beginning in 1986 however, loan loss provisions nearly doubled, and posed a significant earnings drain on Texas banks in general. Part of these losses are traceable to differences in asset composition of the Texas banks.

Table 4 breaks down the assets of the sample banks into their component parts. Overall, the pattern observed by Eisenbeis and Kwast(1989) also seems to hold for the Texas commercial and REBs. Like the national REBS, the Texas REBs held more loans and did so by having fewer liquid assets. The Texas REBs seem to have been even more loaned up than the national REBs, with the main difference being that the Texas banks made more commercial loans than banks nationally; real estate loans are virtually identical for the REBs' samples and the two commercial bank samples.

Looking at the components of the real estate portfolios in the lower panels of Table 4, we see that both the samples of Texas banks held larger portions of what are generally regarded as more risky loans than the national samples. Specifically, the Texas banks held relatively fewer 1-4 family loans and more Construction and Land Development and Non-Farm Non-Residential Property loans than the national groups. This helps to explain the higher provisions and lower earnings, since loans in these categories are where the risky Texas lending activities occurred.

The last table, Table 5 gives the composition of bank liabilities. The erosion of low cost transaction accounts that has been noted nationally also occurs in Texas, but Texas banks still have more of these lower cost funds than institutions nationally. That Texas banks had higher interest expenses with slightly higher ratios of transactions accounts, highlights the problem that risk and the presents of thrifts posed for these institutions.

IV. Summary and Conclusions

The experiences of the thrift industry has raised serious questions about the ability of specialized mortgage lenders to operate profitably and safely. Eisenbeis and Kwast have shown that those commercial banks that have chosen to specialize in real estate lending have been successful through the same period that proved disastrous to the thrifts. The commercial bank real estate specialists have been slightly less profitable than the average bank, their earnings have been less variable. One question that might be raised about the Eisenbeis-Kwast results is the fact that real estate markets have been relatively benign in most of the country for most of this period. A strong test is an analysis of the Texas real estate banks during this period in which the Texas real estate market collapsed. Comparison of the Texas real estate banks with other Texas banks is instructive because the overall Texas economy did not suffer as badly as the real estate sector.

Our results show that concentration on real estate was not a panacea for commercial banks did not seem to disastrous. While Texas real estate banks did worse than other Texas banks, these poor aggregate results for the real estate banks were affected by a small number of banks with huge losses. When these outliers were eliminated, we still find slightly poorer results for the real estate banks. It is important to emphasize, however, that the differences are very slight--an average of 4 basis points over the 1986-1988 period. We interpret this to indicate that even in the face of the worst real estate market faced by lenders since the Great Depression, those banks specializing in such lending had operating results only slightly worse than banks that did not so specialize.

When the current real estate cycle in Texas is over, and the effects of current real estate weakness in the Northeast on real estate banks in that area are available, we may have more complete evidence on the ability of commercial banks to fill safely whatever gap results from the shrinkage of the thrift industry. At this point, however, we believe that this paper provides support for the comforting results of the work of Eisenbeis and Kwast.

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TABLE 1 A DISTRIBUTION OF NUMBER OF BANKS

	YEAR										
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
COMMERCIAL	1372	1399	1451	1500	1578	1691	1806	1846	1862	1646	1344
REAL ESTATE	3		3	2	2	16	28	74	95	108	89

TABLE 1 B DISTRIBUTION OF NUMBER OF BANKS WITH ABS EARNINGS ON ASSETS LESS THAN OR EQUAL TO THE BANK'S CAPITAL RATIO

	YEAR										
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
COMMERCIAL	1371	1398	1449	1498	1575	1681	1784	1803	1785	1342	1344
REAL ESTATE	3	2	3	2	2	16	28	73	88	88	89

TABLE 1 A DISTRIBUTION OF NUMBER OF BANKS

	YEAR										
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
COMMERCIAL	1372	1399	1451	1500	1578	1691	1804	1846	1862	1646	1344
REAL ESTATE	3	2	3	2	2	16	28	74	95	108	89

TABLE 1 B DISTRIBUTION OF NUMBER OF BANKS WITH ABS EARNINGS ON ASSETS LESS THAN OR EQUAL TO THE BANK'S CAPITAL RATIO

	YEAR										
	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
COMMERCIAL	1371	1398	1449	1498	1575	1681	1784	1803	1785	1542	1344
REAL ESTATE	3	2	3	2	2	16	28	73	88	88	89

TABLE 2: PROFITABILITY COMPARISONS - TEXAS BANKS WITH ABS ROA LESS THAN TWICE THE BANK'S CAPITAL RATIO

	ROA				ROE			
Year	COMMERCIAL BANKS	REAL ESTATE BANKS	TEXAS COMMERCIAL BANKS	TEXAS REAL ESTATE BANKS	COMMERCIAL BANKS	REAL ESTATE BANKS	TEXAS COMMERCIAL BANKS	TEXAS REAL ESTATE BANKS
1978	1.003%	0.992%	1.110%	0.988%	12.411%	13.220%	13.624%	12.980%
1979	1.143% **	1.058%	1.316%	0.969%	13.801%	13.462%	15.509%	14.469%
1980	1.187% **	0.895%	1.406%	1.009%	13.717%	10.910%	16.342%	12.699%
1981	1.160% **	0.774%	1.492%	1.263%	13.011%	9.117%	17.260%	14.256%
1982	1.008% **	0.615%	1.242%	1.673%	11.292%	6.981%	14.637%	20.209%
1983	0.853% *	0.665%	0.899%	0.095%	8.907%	5.142%	10.799%	3.468%
1984	0.691%	0.602%	0.615%	0.293%	7.552%	9.715%	8.233%	7.939%
1985	0.564%	0.537%	0.393%	0.343%	6.593%	5.375%	5.210%	6.037%
1986	0.380%	0.476%	-0.086%	-0.119%	1.092%	1.504%	-1.596%	-0.675%
1987	0.433%	0.533%	-0.213%	-0.264%	4.163%	1.757%	-4.753%	-5.327%

TABLE 3: MEAN RATIOS OF SELECTED EXPENSES TO TOTAL OPERATING INCOME (SCREENED DATA)

	TOTAL OPER. EXP/ TOTAL OPER. INC				INTEREST EXPENSE/ TOTAL OPER. INC				NONINTEREST EXPENSE/ TOTAL OPER. INC				LOAN LOSS PROVISIONS/ TOTAL OPER. INC			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	81.33% *	81.91%	78.38%		43.76% **	48.18%	44.80%		37.58% **	33.73%	33.58%		3.61% **	2.50%	3.35%	
1979	80.89% **	82.27%	79.34%	93.433%	46.13% **	50.92%	49.26%	51.553%	34.76% **	31.35%	30.08%	41.880%	3.22% **	2.20%	3.55%	1.000%
1980	82.63% **	86.35%	80.37%	90.565%	50.93% **	56.64%	52.68%	55.556%	31.70% **	29.71%	27.69%	35.010%	3.04% **	2.08%	3.42%	2.444%
1981	85.22% **	89.82%	82.18%	90.776%	57.27% **	61.51%	58.33%	63.286%	27.95%	28.32%	23.84%	27.490%	2.78% **	2.19%	2.95%	2.119%
1982	87.13% **	91.53%	82.68%		58.31% **	61.51%	57.45%		28.83%	30.02%	25.23%		3.86%	3.11%	4.11%	
1983	86.91% **	91.35%	83.17%	80.434%	55.48%	55.44%	55.06%	62.035%	31.43% **	35.91%	28.11%	18.399%	5.23%	4.26%	5.89%	3.026%
1984	88.23%	90.32%	83.78%	81.820%	57.48% **	55.22%	57.61%	60.113%	30.76% **	35.10%	26.17%	21.707%	6.15% **	4.78%	5.74%	3.186%
1985	87.25%	87.88%	84.93%	82.268%	54.41% *	53.44%	55.33%	54.592%	32.84%	34.44%	29.60%	27.676%	8.57% **	6.50%	8.51%	4.910%
1986	88.06%	88.26%	87.88%	86.648%	52.32% **	51.09%	54.88%	54.184%	35.74% *	37.18%	33.00%	32.464%	10.30% **	7.40%	13.72%	13.693%
1987	88.21%	85.93%	88.80%	88.581%	50.40% **	48.46%	54.56%	53.313%	37.81%	37.47%	34.24%	35.268%	8.33% **	6.78%	12.48%	13.959%

TABLE 4: ASSET COMPOSITION COMPARISONS AS A PERCENT OF TOTAL ASSETS (SCREENED SAMPLE)

	LIQUID ASSETS				OTHER ASSETS				TOTAL LOANS				CONSUMER LOANS				COMMERCIAL LOANS			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	31.14% **	23.05%	33.10%	29.224%	20.04% **	10.57%	18.65%	14.190%	50.71% **	68.84%	50.52%	69.435%	17.87% **	14.80%	20.88%	11.863%	12.20% **	7.58%	15.76%	9.082%
1979	30.29% **	21.55%	33.46%	23.540%	21.64% **	13.19%	19.84%	16.417%	48.25% **	65.49%	46.80%	60.044%	16.71% **	13.32%	19.38%	6.666%	11.63% **	6.60%	14.58%	8.378%
1980	32.50% **	23.39%	35.88%	22.346%	21.72% **	13.00%	19.61%	14.890%	45.94% **	63.81%	44.56%	62.764%	15.12% **	11.77%	17.54%	12.823%	11.52% **	6.75%	14.83%	6.249%
1981	34.37% **	24.91%	36.49%	18.790%	21.69% **	12.52%	19.54%	11.557%	44.08% **	62.85%	44.00%	69.653%	13.67% **	10.71%	15.79%	14.570%	11.99% **	7.13%	16.45%	8.293%
1982	35.12% **	25.17%	34.83%	25.338%	21.89% **	12.42%	19.28%	8.894%	43.07% **	62.56%	45.91%	65.767%	12.72% **	9.65%	14.97%	11.081%	12.74% **	7.55%	18.77%	3.256%
1983	36.16% **	24.07%	34.56%	24.382%	21.37% **	12.30%	18.32%	8.416%	42.54% **	63.79%	47.15%	67.781%	12.20% **	9.31%	14.31%	7.030%	12.84% **	8.51%	18.27%	11.448%
1984	35.57% **	22.06%	33.48%	19.072%	19.83% **	11.12%	16.06%	8.807%	44.70% **	67.09%	50.53%	72.122%	12.32% **	10.27%	14.12%	10.445%	13.53% **	10.51%	18.11%	14.041%
1985	35.34% **	21.15%	32.88%	17.495%	18.67% **	10.57%	14.38%	8.532%	46.09% **	68.44%	52.84%	73.973%	12.59% **	10.18%	14.50%	10.078%	13.66% **	11.37%	17.95%	17.154%
1986	36.75% **	21.41%	35.12%	19.672%	17.84% **	10.29%	13.94%	8.895%	45.51% **	68.42%	51.04%	71.555%	12.02% **	9.73%	13.45%	10.322%	12.87% **	11.01%	16.37%	14.864%
1987	37.73% **	21.75%	37.99%	22.000%	17.36% **	10.39%	14.31%	9.689%	45.02% **	68.03%	47.80%	68.311%	11.25% **	9.84%	12.26%	9.233%	12.26% **	10.13%	14.35%	12.799%

TABLE 4 (CONT) REAL ESTATE ASSETS AS A PERCENT OF TOTAL ASSETS (SCREENED SAMPLE)

	OTHER LOANS			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	1.02%	0.93%	1.31%	1.156%
1979	0.90% *	0.76%	1.12%	0.354%
1980	0.86% *	0.72%	0.99%	0.234%
1981	0.85% *	0.69%	0.87%	0.340%
1982	0.85% *	0.69%	0.85%	0.290%
1983	0.80%	0.78%	0.88%	2.289%
1984	1.32%	1.22%	1.34%	0.979%
1985	1.61%	1.51%	1.52%	1.469%
1986	1.53%	1.54%	1.34%	1.263%
1987	1.36%	1.37%	1.25%	1.161%

TABLE 4 (CONT) REAL ESTATE ASSETS AS A PERCENT OF TOTAL ASSETS (SCREENED SAMPLE)

	TOT REAL ESTATE LOANS				CONSTRUCTION AND LAND DEVELOPMENT				LOANS SECURED BY FARM LAND				RESIDENTIAL 1-4 FAMILIES PROPERTY LOANS				MULTI FAMILY GREATER THAN OR EQUAL TO 5 LOANS			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	19.62% **	45.54%	12.57%	47.334%	1.35% **	2.14%	2.25%	6.403%	2.36% **	4.11%	1.31%	0.042%	9.82% **	27.41%	3.95%	14.490%	0.29%**	0.65%	0.19%	0.293%
1979	19.01% **	44.81%	11.74%	44.646%	1.45% **	2.09%	2.38%	4.547%	2.29%**	3.81%	1.20%	0.040%	10.74% **	31.16%	4.39%	23.270%	0.28%**	0.56%	0.18%	0.566%
1980	18.44% **	44.57%	11.20%	43.458%	1.28% *	1.73%	2.14%	1.692%	2.05% **	2.96%	1.00%	0.017%	10.65% **	31.68%	4.38%	29.737%	0.27%**	0.59%	0.18%	0.366%
1981	17.57% **	44.32%	10.90%	46.451%	1.21% **	1.65%	2.12%	0.376%	1.82% *	2.42%	0.83%	0.000%	10.26% **	31.56%	4.33%	30.405%	0.26%**	0.67%	0.19%	0.223%
1982	16.76% **	44.68%	11.34%	51.141%	1.19% **	2.25%	2.43%	1.225%	1.64%	2.16%	0.71%	0.000%	9.75% **	31.00%	4.41%	48.924%	0.26%**	0.92%	0.21%	0.240%
1983	16.70% **	45.19%	13.68%	47.014%	1.36% **	4.61%	3.36%	15.849%	1.58%	1.99%	0.70%	0.207%	9.52% **	27.94%	5.08%	19.164%	0.28%**	1.26%	0.27%	1.179%
1984	17.54% **	45.10%	16.96%	46.657%	1.63% **	6.85%	4.29%	15.823%	1.64%	1.52%	0.77%	0.778%	9.71% **	25.13%	6.13%	17.195%	0.33%**	1.17%	0.40%	0.779%
1985	18.24% **	45.39%	18.87%	45.273%	1.73% **	6.83%	4.32%	13.990%	1.69% *	1.35%	0.78%	0.676%	9.95% **	24.38%	7.09%	16.688%	0.35%**	1.27%	0.43%	1.193%
1986	19.09% **	46.14%	19.88%	45.108%	1.72% **	6.66%	3.79%	10.971%	1.84% **	1.41%	0.84%	0.785%	10.24% **	24.26%	0.78%	18.647%	0.38%**	1.29%	0.47%	0.972%
1987	20.16% **	46.69%	19.94%	45.118%	1.60% **	5.36%	2.80%	8.502%	2.12% **	1.63%	1.04%	2.171%	10.78% **	25.52%	8.20%	19.146%	0.40%**	1.15%	0.46%	1.005%

TABLE 4 (CONT) REAL ESTATE ASSETS AS A PERCENT OF TOTAL ASSETS

	NON FARM NON RESIDENTIAL PROPERTY LOANS			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	4.05% **	6.74%	3.41%	15.165%
1979	4.19% **	7.10%	3.52%	16.142%
1980	4.14% **	7.55%	3.46%	11.556%
1981	3.98% **	7.95%	3.35%	15.427%
1982	3.87% **	8.28%	3.52%	0.728%
1983	3.90% **	9.32%	4.18%	10.586%
1984	4.13% **	10.10%	5.21%	11.626%
1985	4.43% **	11.38%	6.09%	12.364%
1986	4.82% **	12.35%	6.88%	12.933%
1987	5.17% **	12.86%	7.31%	14.455%

TABLE 4 (CONT) DISTRIBUTION OF REAL ESTATE LOANS BY TYPE AS PERCENT OF REAL ESTATE LOANS

	CONSTRUCTION AND LAND DEVELOPMENT				LOANS SECURED BY FARM LAND				RESIDENTIAL 1-4 FAMILIES PROPERTY LOANS				MULTI FAMILY GREATER THAN OR EQUAL TO 5 LOANS				NON FARM NON RESIDENTIAL PROPERTY LOANS			
	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE	COMM BANKS	REAL ESTATE	TEXAS COMM BANKS	TEXAS REAL ESTATE
1978	6.90% **	10.91%	17.88%	13.527%	12.04% **	9.03%	10.42%	0.09%	47.22% **	60.11%	31.45%	30.61%	1.56%	1.40%	1.47%	0.62%	21.85% *	14.93%	27.17%	32.04%
1979	7.61% **	10.99%	20.29%	10.185%	13.31% **	8.50%	10.18%	0.09%	53.04% **	69.38%	37.41%	52.12%	1.51% *	1.24%	1.52%	1.27%	23.10% *	15.94%	30.02%	36.16%
1980	6.95% **	9.37%	19.06%	3.893%	12.49% **	6.65%	8.88%	0.04%	54.21% **	70.93%	39.09%	68.43%	1.44%	1.31%	1.62%	0.84%	23.41% **	17.06%	30.84%	26.59%
1981	6.87% **	9.38%	19.45%	0.809%	12.02% **	5.47%	7.60%	0.00%	54.76% **	70.97%	39.76%	65.46%	1.45%	1.46%	1.77%	0.48%	23.50% **	18.12%	30.78%	33.21%
1982	7.12% **	13.45%	21.43%	2.395%	11.60% **	4.83%	6.22%	0.00%	54.81% **	69.12%	38.87%	95.66%	1.51%	1.96%	1.88%	0.47%	23.76% **	18.76%	31.00%	1.42%
1983	8.13%	27.58%	24.54%	33.711%	11.43% **	4.39%	5.09%	0.44%	54.54% **	61.46%	37.14%	40.76%	1.67% **	2.68%	1.96%	2.51%	23.63% *	21.03%	30.52%	22.52%
1984	9.32% **	39.06%	25.31%	33.913%	11.69% **	3.36%	4.53%	1.67%	53.78%	55.64%	36.12%	36.85%	1.79% **	2.55%	2.35%	1.67%	23.37%	22.70%	30.73%	24.92%
1985	9.47% **	37.44%	22.86%	30.901%	11.95% **	2.97%	4.13%	1.49%	53.45%	53.47%	37.58%	36.86%	1.81% **	2.70%	2.25%	2.64%	23.67%	25.16%	32.26%	27.31%
1986	8.99% **	34.88%	19.04%	24.322%	12.66% **	3.06%	4.21%	1.74%	52.68%	52.36%	3.91%	41.34%	1.89% **	2.72%	2.35%	2.15%	24.22% **	26.99%	34.59%	28.67%
1987	7.92% **	26.61%	14.04%	18.844%	13.73% **	3.48%	5.20%	4.81%	52.41% **	54.44%	41.11%	42.44%	1.85% **	2.41%	2.29%	2.23%	24.38% **	27.74%	36.64%	32.04%

TABLE 5: RATIOS OF SELECTED LIABILITIES / TOTAL LIABILITIES (SCREENED DATA)

	DD + NOWS/ TOTAL LIABILITIES				T & SAVINGS DEP / TOTAL LIABILITIES				OTHER LIABILITIES / TOTAL LIABILITIES			
	COMMERCIAL BANKS	REAL ESTATE BANKS	TEXAS COMMERCIAL BANKS	TEXAS REAL ESTATE BANKS	COMM BANKS	REAL ESTATE BANKS	TEXAS COMMERCIAL BANKS	TEXAS REAL ESTATE BANKS	COMM BANKS	REAL ESTATE BANKS	TEXAS COMMERCIAL BANKS	TEXAS REAL ESTATE BANKS
1978	34.383%**	26.268%	43.049%	40.034%	63.182%**	71.635%	54.910%	55.862%	1.637%**	1.235%	2.518%	5.132%
1979	32.756%**	23.876%	41.232%	26.369%	64.252%**	73.771%	56.353%	66.840%	1.585%**	1.105%	2.376%	2.900%
1980	30.175%**	22.138%	38.858%	25.333%	66.594%**	75.306%	58.474%	70.590%	1.497%**	1.031%	2.325%	2.578%
1981	25.115%**	19.848%	32.661%	27.161%	70.985%**	77.210%	64.231%	69.718%	1.460%**	1.017%	2.290%	2.091%
1982	21.286%**	17.815%	27.384%	16.103%	74.320%**	78.648%	69.075%	80.466%	1.419%	1.301%	2.226%	3.656%
1983	18.963%**	16.833%	23.737%	15.769%	77.332%**	79.981%	73.005%	81.657%	1.385%*	2.109%	2.244%	8.453%
1984	21.711%**	20.002%	25.121%	19.511%	74.285%**	75.743%	71.498%	77.407%	1.037%**	1.350%	1.350%	1.287%
1985	16.544%**	15.472%	19.718%	15.735%	80.200%	80.664%	77.594%	80.699%	0.878%*	1.223%	1.059%	1.849%
1986	16.162%	15.830%	18.288%	15.602%	80.908%	80.970%	79.550%	81.959%	0.853%**	1.143%	0.873%	0.913%
1987	15.552%	15.344%	16.818%	15.347%	81.570%	81.675%	81.186%	82.887%	0.789%*	1.049%	0.773%	0.960%

* Significantly different from REB at the 95 percent level or better

** Significantly different from REB at the 99 percent level or better

Are Real Estate Specializing Depositories Viable?

Evidence From Commercial Banks

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Are Real Estate Specializing Depositories Viable? Evidence From Commercial Banks

I. Introduction

The current "FSLIC crises" is the latest manifestation of a series of problems that have plagued the thrift industry since the 1960s. A flash point of tension over this problem is concern about the continued viability of specialized depository institutions, and most particularly of real estate specialized firms. Some observers maintain that the thrift industry, at least as the American economy has known it, is obsolete. Others argue that specialized real estate depositories are vital to the continued flow of an adequate level of funds to housing.[1] The crucial issue is whether depository institutions that specialize in real estate lending are economically viable on their own.

This study investigates the question of the viability of real estate specialized depositories by examining the behavior of commercial banks that have chosen, absent the special subsidies available to thrifts, over the last decade to specialize in real estate lending..[2] It builds on earlier work by the authors which found that the average real estate specializing bank significantly outperformed, in terms of several criteria, both savings and loans and more diversified commercial banks.[3] These results were surprising, but were open to question about their generality because of several unique aspects of the sample period. For example, deposit rate ceilings were in effect over the entire 1970-1979 sample period, and the regulators actively attempted to insulate depository institutions from the effects of disintermediation. Finally, housing markets were generally healthy. For these reasons, it was unclear whether the benefits of specialization would hold up either in a deregulated environment or in times of severe economic pressures on the housing industry.

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[1] This concern was manifested in the Financial Institutions Recovery, Reform and Enforcement Act of 1989 which increased the Qualified Thrift Lender test and required them to expand their holdings of traditional housing and related real estate loans.

[2] These subsidies included: favorable tax treatment in terms of additions to loan loss reserves, differential interest rate ceilings, access to subsidized credit in the form of Federal Home Loan Bank advances, and capital forbearance in times of volatile interest rates.

[3] See Eisenbeis and Kwast (1982) and Eisenbeis (1982).

The current study deals with both of these concerns. The period of study, 1978 through 1988, includes a full macroeconomic and interest rate cycle. Indeed, the volatility of interest rates during the early part of this period was greater than at any time since World War II, and the recession of 1981-1982 was the most severe since the Great Depression. Moreover, for more than half the period, deposit rate ceilings did not constrain banks' ability to compete for funds. Money market certificate accounts were authorized early in the period, the Garn-St Germain Act of 1982 authorized two accounts for banks and thrifts offering market rates, and the phase-out of deposit rate ceilings mandated by the Monetary Control Act of 1980 was completed by the fall of 1983. Finally, in many parts of the country, the 1978-1988 period included times of extreme duress for the housing industry. Thus, this period is one in which it should be possible to determine how real estate specializing firms would be able to perform under severe pressures.

The next section discusses sample selection procedures and presents a background description of the real estate and non-real estate banks. Succeeding sections discuss risk characteristics, profitability and operating costs, and asset and liability composition of the sample banks. The final section presents a summary and advances some policy conclusions.

II. Sample Selection and Background Description of the Data

The data employed consist of annual balance sheet and income statement information on three sets of commercial banks from 1978 through 1988.[4] The first sample represents the broadest set of real estate specialized banks (REBs), and it consists of all banks that held 40 percent or more of their total assets in loans secured by real estate in any one of the 11 sample years.

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[4] Asset and liability data are from publicly available consolidated Call Reports of Condition (balance sheet) submitted to the federal bank regulatory agencies. Income and expense data are also derived from publicly available income statements submitted to the federal bank regulatory agencies. Balance sheet items are a weighted average of December, June, and December figures. The averaging procedure used is that recommended by Lloyd-Davies (1977), which assumes that exogenous inflows to assets are a constant proportion of assets.

The second, more limited set of real estate specialized banks considered is that sub group of REBs appearing in the sample for five or more years (5REBs). These banks were chosen in order to isolate institutions that could be viewed as long-term specialists in real estate lending. It is hypothesized that such banks may differ significantly from banks only meeting the REB criteria for a relatively short period of time. For example, banks that are "locked into" real estate lending may be less capable of responding to changed economic conditions and hence may prove to be more vulnerable. The condition of the long-term REBs may also provide a more meaningful contrast to the condition of savings and loans over the sample period.

The criterion of a minimum of 40 percent of total assets in real estate loans was chosen in a practical attempt to balance the strictness of the definition of "specialized" with the need for reasonable sample size.[5] The 40 percent criterion also parallels fairly closely the 65 percent of total loans criterion used in the authors' previous study.[6] Lastly, the 40 percent rule was considered reasonable in part because it is close to the ratio that Baker(1982) found new state chartered savings and loans in Florida to hold. Baker hypothesized that his sample of new S&Ls could be viewed as being reasonably representative of what a voluntarily specialized real estate depository institution might look like.

The third sample is a control group of virtually all other commercial banks (CBs) of similar size to the REBs. Other than the REBs, three kinds of banks were excluded from this control group: those banks with total assets exceeding the total assets of the largest REB in each year, banks with zero real estate loans, and the 71 savings and loans that had converted to commercial banks within three years of an observation date. Large banks were excluded to minimize any bias due to size. Banks with zero real estate loans were dropped because bank-by-bank examination revealed that the vast majority of such banks were special purpose firms, such as nonbank banks and trust companies, whose inclusion in the control sample would introduce extreme values in some of the ratios. In any given year this exclusion resulted in the deletion of between 97 and 132 banks from the CB sample. Finally, former S&L's were excluded because such institutions could severely distort the characteristics of the real estate bank sample.

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[5] As an alternative to the 40 percent criterion, the feasibility of using those banks that met the "Qualified Thrift Lender" (QTL) test contained in the Competitive Equality in Banking Act of 1987 was investigated. To pass the QTL test a thrift had to hold, on average over a given four month period, 60 percent or more of its tangible assets in certain "qualified thrift investments." While the precise data needed to apply the thrift test to commercial banks were not available in the bank call report data, a proxy test was constructed, similar to that employed by the Federal Home Loan Bank Board (now the Office of Thrift Supervision) to monitor thrift compliance. When the proxy was used to determine how many banks might meet the requirement (over 1978-87), the maximum number of banks in any one year was 35, and for three years only 1 bank met the standard. This obviously was too small a sample for analysis.

[6] However, it is important to realize that 40 percent of total assets does not represent an important discontinuity in the distribution of the degree of concentration in real estate lending across banks.

One last screening of the entire data set of real estate and commercial banks was performed. Institutions were eliminated whose absolute value of their ROA was greater than **twice** the absolute value of the ratio of their (Equity)/(Total Assets), measured on a GAAP (Generally Accepted Accounting Principles) basis. Banks with such a large negative ROA de facto failed twice during the year because their negative ROA used up more than twice their equity capital. It was feared that inclusion of such banks might distort certain aggregate financial ratios, such as returns on equity.[7] It was decided to treat these "outliers" as *de facto* failures (discussed in Section 3 below). Of the 413 banks (36 REBs and 377 CBs) that met the screening criterion at some time during the 1978-1988 period, all but 4 did so because of extreme negative values on ROA.[8] Of the banks that were screened out, 355 (86%) were deleted in the years 1985 through 1988. Finally, the overlap between these 413 banks and banks that eventually "officially" failed is great -- 283 (69%). The remainder were either merged or permitted to continue operating due to regulatory forbearance.

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[7] Comparison of tables construced using the unscreened sample with those using the screened sample through 1987 revealed that sample selection had generally insignificant effects on ratios for both the real estate and regular commercial banks with the except of a few of the earnings performance numbers in the later years for the REBs. Overall, the conclusions of the study would have been essentially unaffected if the screening process had not been undertaken.

[8] The 4 banks that met the criteria because of extremely high ROAs were also deleted. Banks that were not closed had great incentives to trade on deposit insurance guarantees.

Background Sample Description

Table 1 lists the number and size distribution of banks in the three samples by year. The time patterns of the numbers of banks qualifying for the REB and 5REB samples suggest that there was substantial churning among the real estate banks as the proportion of their assets in real estate loans changed. For example, the number of REBs starts with a relatively large number of banks (956) in 1978, declines steadily to a minimum of 207 in 1983, and thereafter rises, reaching the maximum 1328 in 1988. This time pattern follows closely the trend in interest rates, with a slight lag at the trough. It also suggests that the portfolio adjustment behavior of the sample banks will be a interesting topic for analysis. Overall, there are 2439 different REBs that appear in the sample over the decade. Of these, only 341 make it into the 5REB subsample; over half (1548) were in the sample for less than three years.

The data in Table 1 also indicate that the sample of REBs is concentrated, as are most banks in the country, in the $10 million to $100 million asset size categories. In addition, the change in the size distribution of REBs over the sample decade largely mirrors that of banks generally. However, it is still noteworthy that the sample permits performance generalizations for a wide range of different size banks. In 1988, there were 391 REBs with total assets over $100 million, 29 banks with between $500 million and $1 billion, and 22 banks with total assets over $1 billion.

Deeper investigation of the sample suggested three additional interesting characteristics of the real estate specialized banks. First, over the 1978-1988 period there was a significant geographic shift in the location of the REBs away from the North Central part of the country, especially Wisconsin and Minnesota, and toward those areas that were experiencing, or would soon come to experience, serious problems in real estate lending, namely Texas, California, and Florida. This suggests that regional factors may importantly affect both the desirability of continued specialization and the attractiveness of specialization versus diversification. Second, relative to the CB sample, the REBs became substantially more urbanized over the decade. The proportion of CBs located in urban areas remained essentially constant at between 41-44 percent; the percent of REBs rose from 42 percent in 1978 to 64 percent in 1988; it peaked at 67 percent in

1986. Third, the proportion REBs affiliated with bank holding companies became more like that of the control sample of commercial banks. By the end of 1988, 69 percent of the CBs, and 71 percent of the REBs were holding company affiliates.

III. Risk Characteristics

This section analyzes selected risk characteristics of the sample banks, and realized ex post failure rates are also considered. Table 2 displays aggregate measures of risk, and Table 3 presents risk measures derived from less aggregated portions of balance sheet and income statements.

Aggregate Risk Measures

Columns 1 and 2 of Table 2 give the mean net rate of return on assets and the standard deviation of those returns, respectively.[9] Column 3 gives the mean ratio of equity capital to total assets, and column 4 contains a summary measure of risk called here the "typical Z." For an individual bank, the Z-score is a summary indicator of the ex ante probability of failure, where failure is defined to occur when recognized losses exceed book equity.[10] The Z-score is defined as the sum of the mean net return on assets plus the mean ratio of equity to assets divided by the standard deviation of the return on assets. Thus, Z incorporates three standard elements of a bank's risk into one summary statistic. Intuitively, "Z is the number of standard deviations below the mean by which profits would have to fall in order to eliminate equity," and it is in this sense that Z is an inverse measure of the probability of failure.[11] In Table 2, the "typical Z" is computed from the data given in columns 1-3, and not derived from a bank-by-bank calculation. Thus, the reported Z-scores are best interpreted as a representation of the average or "typical" bank.

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[9] For it to be appropriate to use the cross-section data to estimate the variance of returns, a necessary assumption is that observed differences in returns across banks are due more to different draws from the same exogenous distribution of returns than to different endogenous portfolio choices of firms. For more on these points see Kwast (1989 and 1988).

[10] Since the bank call and income data employ GAAP, and not market value accounting, failure is more accurately defined to occur when recognized losses exceed book equity. However, in principle, the Z-score approach can be used with any accounting methodology.

The data in columns 1-3 of Table 2 suggest that the years 1982-1983 were a watershed in the comparisons among the sample banks but provide a somewhat ambiguous picture in terms of the riskiness of the REBs as compared with commercial banks. On the one hand, after 1983 rates of return at the REBs were generally the same or greater than those at the CBs, but the standard deviation of returns remained smaller at the real estate banks. The differences are even greater for the 5REBS. For example, from 1984 on the ROA at the long-term real estate banks is greater than CBs, and the standard deviation of returns is significantly lower. On the other hand, the data in column 3 show that the equity ratio of the average REB was consistently below that of the average CB, and the equity ratio of the average 5REB was even lower.

Examination of the Z-scores in column 4 helps to resolve the ambiguity of columns 1-3. Here it is readily seen that the Z-score of the typical long-term real estate bank (5REB) is greater than that of the typical REB or CB bank over the entire sample decade, implying 5REBs were less risky. In contrast, the REB Z-scores start out above those of the CBs, drop below the CB score in 1982, stay in this position until 1985, fall below again in 1987, and finally rise above in 1988. Indeed, from 1980 on it is probably a close call as to whether the REBs or CBs have the lowest ex ante probability of failure. A final and remarkable characteristic of the Z-scores is the general downward trend for all three sets of banks. This suggests an upward drift in the riskiness of banks over the decade, despite considerable efforts by regulators to increase bank capital and control bank riskiness.[12]

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[11] Boyd and Graham (1988), p. 5. Technically Z derives directly from the probability of failure only if ROA is distributed normally. Even if returns are not distributed normally, Z can be viewed as an upper bound on the probability of failure.

Disaggregate Risk Measures

Table 3 presents information on four disaggregate risk measures: (1) the mean ratio of net loan losses (charge-offs minus recoveries) to total loans, (2) the mean ratio of loans 90 or more days past due but still accruing interest to total loans, (3) the mean ratio of real estate loans 90 or more days past due but still accruing interest to real estate loans, and (4) the mean ratio of repossessed real estate to gross real estate loans. Column 1 of Table 3 clearly shows that loan loss rates were similar at both sets of real estate banks, but significantly higher (by a factor of about two) at the CB sample. This pattern of superior performance for the REB and 5REB samples does not show up in past due loans, column 2, until 1986. Even then, the differential is smaller.[13] Looking more deeply at the loan portfolio, column 3 suggests that past due real estate loan ratios are about the same at the two sets of real estate banks, but significantly higher at the commercial banks. Column 4 reports mean (primarily) repossessed real estate loans to total real estate loans.[14] The steady deterioration of the real estate portfolios of all three groups is evidenced by the fact that this ratio more than doubled over the period. However, the ratios were always lower at the two sets of real estate banks, and after 1982, the differences remained nearly level at rates about one third that of regular commercial banks.

Thus, while the real estate banks hold a significantly higher percentage of their total assets in real estate loans, these loans are, on average, substantially less risky than real estate loans held by less specialized banks. This impression is supported by data not shown in the tables; the ratios of nonaccrual and renegotiated real estate loans to gross real estate loans are generally comparable for the two groups of real estate banks, and significantly higher at the commercial banks.[15] [16] Also, mean gross rates of return on real estate loans (available beginning in 1984) are generally comparable across all three sets of banks, but mean net loss rates on real estate loans (also available beginning in 1984) are always lower at the two sets of real estate banks. Loss rates at the real estate banks are generally one-third to one-half those at CBs.

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[12] The causes of this upward drift continue to be debated, but undoubtedly include local, national, and international shocks to the real and financial sectors of the economy, and probably accentuation of the problem of moral hazard inherent in the federal safety net for depository institutions. For more on these points see Keeton and Morris (1987), Kling (1986), and Benston et. al. (1986).

[13] Data on past due loans are not available until 1983.

[14] The item reported is "other real estate owned" which is primarily real estate acquired as part of loan foreclosures.

Failure Rates

Ex post failure rates among the REB and CB samples are consistent with the view that the real estate banks are probably less risky than other banks. From 1979 through 1988, the failure rate of the REB sample was 3.1 percent, slightly over half the 5.4 percent rate for the CBs.[17] Of the 75 REB failures, 9 (12 percent) were de facto failures as defined earlier.[18] Similarly, of the 905 CB failures, 121 (13 percent) were de facto failures.

IV. Profitability and Operating Expenses

As was suggested in the previous section, and may be seen in the first set of columns in Table 2, the years 1982-1983 are something of a watershed in the relationship between profitability at the two sets of real estate banks and other commercial banks. Prior to that time,the net return on assets was generally higher at regular commercial banks. But beginning in 1984 there is no significant difference in the mean ROAs at the REB and CB samples, and the mean ROAs at the 5REBs are significantly higher than those in the other samples. This result is generally robust even if the samples are divided into banks with $50 million or less in total assets, and those with more than $50 million in assets. In addition, there is a distinct drop in ROA at all three sets of banks after 1980. This general decline has come to be associated with the 1980 legislation that began the removal of deposit rate ceilings, the increased competition that came with the ensuing deregulation, and the severe macroeconomic conditions of the early 1980s, some of which have continued into the latter part of the decade. However, it is again noteworthy that this drop was considerably less severe at the long-term real estate banks.[19]

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[15] Equivalent ratios for commercial and industrial loans, consumer loans, and agricultural loans tell the same story. For each type of loans and each class of troubled loans, troubled loan ratios for the two sets of real estate banks are comparable, and are the same or significantly higher at other commercial banks.

[16] Furthermore, it also appears to hold despite the geographic change in the concentration of real estate banks.

[17] Only one REB failed before 1982, and 11 failed in 1987.

[18] That is, for at least one year they had a negative ROA more than twice their equity to assets ratio.

Table 4 shows various components of operating expenses as a percent of total assets at the three sets of banks. Looking at the first set of columns, through 1983 the three groups of banks had about the same operating expenses, and if there were any advantages they were with the CBs. After 1983, the REBs and 5REBs expense ratios were about the same, and both were at a significant disadvantage when compared with CBs.

The breakdown of total operating expenses into interest and noninterest expenses in the next two sets of columns sheds a little more light. Both the REB and 5REB banks generally have higher interest expenses until 1983, drop down comparable with CBs until 1985, and then generally rise above the CBs again. Noninterest expenses, shown in the third set of columns, also suggest a complex story. An initial cost advantage enjoyed by both sets of real estate banks eroded over time, until by 1982 for the REBs (1983 for the 5REBs) there was no significant difference. By 1984, however, the REBs experience a cost disadvantage which persists through 1988.

The last three columns in Table 4 show loan loss provisions as a percent of total assets and, under GAAP accounting, should reflect expected losses over the relevant accounting period. It is clear that both sets of real estate banks provisioned at a lower rate over the sample decade, and that provisioning headed sharply up after 1981 at all three groups. In addition, from 1983 on, the long-term real estate banks provisioned at a significantly lower rate than the REBs and the CBs.

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[19] Comparison of the mean return on equity across the three sets of banks provides a more mixed picture, but generally follows the patterns of the ROA comparisons. In particular, the general downward trend in ROE at the REBs and the CBs was resisted by the 5REBs across size classes of banks. ROE comparisons must, of course, be viewed with some caution since they do not control for leverage.

The lower rate of provisioning at both sets of real estate banks is consistent with the analysis in section III which suggested that the real estate banks, and especially the 5REBs, tended to be less risky than the other commercial banks. Thus, once again the evidence suggests that it is unlikely that the higher returns on assets at the 5REBs during the latter years of the sample period were due to risk premia associated with their having riskier loan portfolios.

Overall, the results imply that the superior ROA operating performance of the real estate banks came from higher returns on less risky assets, and not from a cost advantage in terms of either interest or noninterest operating expenses. Indeed, these institutions are at a cost disadvantage that is only mitigated somewhat by lower loan loss experience. Lower loan losses are only part of the story. If the REBs and 5REBs had provided for loan losses at the same rate as CBs between 1986 - 1988, they still would have generally had higher ROAs than the CBs.

V. Asset and Liability Composition

The breakdowns of the principle asset holdings (as a percent of total assets) of real estate and commercial banks are shown in panel A of Table 5, and the distributions of loans among the various real estate categories are shown in panel B. Four important differences are evident among the groups of banks. First, the real estate banks held more than twice the proportion of their assets in real estate loans than did regular commercial banks. These percentages drop between 1978 and 1982 for regular commercial banks and the 5REBs by about 3-4 percentage points, and then climb back to their 1978 levels by 1987. Second, the main asset reallocation into real estate loans came from assets that other commercial banks would have held in liquid assets and in the other asset category. Overall, the two real estate bank samples were much more loaned up than other banks. Total loans at real estate banks averaged about 62-68 percent as compared with 45-50 percent for commercial banks. Third, the allocation of assets to consumer loans declined for both real estate bank samples and for commercial banks over the period, and was generally lower for real estate banks than for commercial banks. Finally, the proportion of assets in traditional commercial loans increased over the period for REBs, and by 1988 was only about two percentage points less than the mean ratio for regular commercial banks. While there was a similar trend at the 5REBs, the mean ratios at the 5REBs remained substantially lower than those at the CBs over the entire decade.

Perhaps the most interesting comparison of the real estate lending patterns is revealed by the composition of real estate loans in panel B of Table 5. Despite the fact that real estate banks hold over twice the proportion of total assets in real estate loans as regular commercial banks, there are certain similarities in the distributions of loans across the various category types. For example, traditional 1-4 families loans dominate the real estate loan portfolios of all three groups. Nevertheless, the ratio is some 10 percentage points higher for real estate banks over the first half of the sample period, and the proportions are even higher for the 5REB banks. The next largest category for all three groups is nonfarm nonresidential property loans, which are loans secured primarily by commercial-type buildings.[20] This ratio was lower for the real estate banks at the beginning of the period and then increased rapidly to proportions approximating, or exceeding, those for regular commercial banks. Construction and land development loans, the cause of significant problems in many S&Ls, increased only at both samples of real estate banks. However, the average ratio never exceeded 15 percent of real estate loans for the REBs, and 9 percent for both the 5REB banks and regular commercial banks.[21]

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[20] Included in this category are "loans secured by real estate as evidenced by mortgages or other liens on business and industrial properties, hotels, motels, churches, hospitals, educational and charitable institutions, dormitories, clubs, lodges, association buildings, 'homes' for aged persons and orphans, golf courses, recreational facilities and similar properties" but excluding loans to nonfarm residential property construction and land development purposes maturing in 60 months or less. Source: Federal Financial Institutions Examination Council Report of Condition.

A recent survey of senior loan officers suggests that a substantial proportion of these loans may in fact be traditional C&I loans that are collateralized (secured) by real estate. For example, the survey found that real estate secured C&I loans accounted for about six percent of the real estate loans at the 50 respondents. Thus, such lending could account for 25 percent or more of the nonfarm nonresidential ratios given in panel B of table 5. Also, while the majority of survey respondents reported no significant differences between the purposes of real estate secured C&I lending and standard C&I loans, respondents did suggest that borrowers using real estate secured C&I loans tended to have higher a priori credit risk than did other C&I borrowers. For more on these points see Board of Governors (1989).

Overall, these data suggest that the higher returns on assets for REBs are due largely to the shift in assets from lower yielding liquid assets into higher yielding mortgage loans. In addition, the churning of the real estate sample, and the increase in the number of banks from the low of 207 in 1983 do not appear to have been primarily the result of a shift in emphasis of real estate lending from residential to construction and land development lending. A more important change appears to have been the shift toward the nonfarm nonresidential property category.[22]

The potential implications of a shift from residential lending to nonfarm nonresidential and construction and land development credit was investigated further by calculating the mean Z-scores and the mean values of a variety of troubled loan ratios for three additional subsets of the REB sample. Risk measures were computed for each sample year for (1) banks with a ratio of 1-4 families residential loans to total real estate loans above that year's mean of the REB sample, (2) banks with a ratio of nonfarm nonresidential property loans to total real estate loans above that year's mean of the REB sample, and (3) banks with a ratio of construction and land development loans to total real estate loans above that year's mean of the REB sample. These indicators were compared with each other and with those of the appropriate group of "below average" banks.

These experiments suggest that, on average, banks which tended to specialize in 1-4 families mortgage loans were less risky than other real estate banks, and that, in particular, a move toward construction and land development loans tended to increase risk. For example, the Z-score of the average "residential REB" exceeded (indicating a lower probability of failure) that of the average "commercial REB" in seven of the eleven sample years, and exceeded the Z-score of the average "development REB" in all but one year. Looked at another way, the Z-score of the average residential REB was larger than of the average "other REB" in nine years; and the Z-score of the average development REB was less than that of the average other REB for also nine years. Lastly, from about 1985 on, mean net charge-off rates show significant differences. From 1985 through 1988, net charge-off rates are lower at residential REBs than at other REBs. From 1986 through 1988 mean net charge-off rates are higher at development REBs than at other REBs, and this pattern begins for commercial REBs in 1987.

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[21] These percentages reflect mean ratios computed separately for banks with total assets exceeding $50 million.

[22] The much publicized growth in mortgage-backed securities did not, on average, comprise a significant component of either real estate or regular commercial bank portfolios. Data on mortgage-backed securities first became available for all banks in 1984. On average they accounted for less than 2 percent of the assets of the real estate banks and well under 4.5 percent at their peak for the CBs. However, it is true that holdings of mortgage-backed securities have grown rapidly at many banks in recent years.

Another interesting aspect of the portfolio behavior of the REBs is their ability to adjust quickly the relative size of their real estate assets over time. Table 6 shows how various sample banks adjusted their RETA ratios (the percent of total assets held in real estate loans) over the ten year sample period. The first two columns of the table repeat, for convenience, information presented elsewhere in this study. In column 1 it is seen that the commercial bank sample held a fairly constant 17 to 21 percent of total assets in real estate loans, and column 2 shows that the full REB sample held a rather steady average level of around 45-46 percent. Column 3 gives the mean RETA ratio for the 32 banks that appear in the REB sample in all 11 years. This ratio clearly fluctuates over the macroeconomic cycle, but tends to remain in the 47 to 51 percent range; it does, however, shoot up to 55 percent in 1988. In short, the mean RETA ratio of each of these three sets of banks holds fairly steady over the entire eleven years.

The last three columns of Table 6 tell a much different story. These columns give mean RETA ratios (and the number of banks used to compute those ratios) for banks that, while they do not appear in the REB sample in a given year, do appear for one (column 4), four (column 5), and seven (column 6) other years. For example, column 4 indicates that in 1978 there were 411 banks that did not appear in 1978's REB sample, but did appear in the REB sample one other year, and that the mean RETA ratio of these 411 banks was 26 percent in 1978. These last three columns suggest that in years they did not meet this study's definition of a real estate specialized bank, the downward adjustment in the REBs's holdings of real estate loans was substantial, even for banks that were in the REB sample for well over half the period. Banks that were in the REB sample between one and four years dropped their mean RETA ratio to between 24 and 33 percent in the off-years. Even banks that were in the REB sample for seven other years dropped their percent of assets held in real estate loans to between 30 and 38 percent. These data clearly indicate that the REBs were able to adjust their concentration in real estate lending from means of around 45 percent of total assets when they qualified for the REB sample down to means as low as 24 percent rather quickly. While these off-year percentages are not as low as the CB ratios given in column 1 of Table 6, they do suggest that the real estate specialized banks had a substantial ability to adjust quickly their degree of concentration in real estate lending.

Turning to the liability side of the balance sheet, decomposing the institutions' liabilities is important for understanding why regular commercial banks experienced an interest expense advantage when compared to REBs. These patterns could arise from different liability compositions, from differences in deposit markets (recall that real estate banks became relatively more urban over the period than did the CBs), or some combination of these and perhaps other factors.

Table 7 shows that regular commercial banks had, on average, a larger proportion of their liabilities in transactions accounts (NOWs and demand deposits) up through 1985. This differential narrowed relative to the REB sample, but remained significantly above that of the 5REB sample, even after 1985. Thus, real estate banks tended to fund themselves with higher rate liabilities, and this probably explains the higher cost of funds of the real estate banks. Interestingly, for all three groups the proportion of liabilities in transactions accounts fell significantly over the entire period, especially for regular commercial bank.. By 1988, there was little difference in the split between transactions accounts and time and savings deposits between the REBs and the CBs, regardless of size, while the 5REBs continued to have a lower proportion of transactions accounts. Conversely, the 5REBs had higher portions of time and savings deposits than commercial banks, and the REBs had higher portions of other liabilities, both of which represent higher funding costs than transaction accounts.

VI. Summary and Conclusions

This study strongly suggests that small to medium sized real estate specialized depositories are economically viable, even without the special subsidies provided savings and loans. Over the 1978 through 1988 period, the average REB performed quite adequately, while the longer-term specialized institutions substantially outperformed even regular commercial banks. Moreover, the real estate bank samples were, using a variety of risk measures, no more risky than other commercial banks. Indeed, the subsample of long-term REBs was, on average, less risky over the entire period. This conclusion regarding the economic viability of real estate specialized depositories appears to be quite robust, in part because it is consistent with results from a similar study by the authors that covered 1970-1979.

The superior performance by real estate specializing institutions appears to be explained primarily by their ability to identify high yielding low risk lending opportunities. These institutions had a relatively lower rate of loan losses, and correspondingly lower rate of loan loss provisioning, over the entire period. A second, and closely related reason, for the real estate banks' performance is their higher ratio of loans to total assets.

One to four families mortgage loans dominate the real estate loan portfolio of the average real estate bank. However, the decade saw some movement toward commercial real estate lending and, to a lesser degree, toward construction and land development loans. There is some evidence that this latter movement, in particular, tended to increase the riskiness of the REBs. Finally, real estate banks appear to be able to adjust their real estate loan holdings quite rapidly and to a substantial degree.

One important caution arises from this work, especially in view of provisions in the recently enacted FIRREA requiring S&Ls to increase their specialization in traditional real estate lending. While the loan-to-asset ratios of the real estate bank samples and S&Ls appear to be similar, the real estate banks are much less concentrated in mortgage lending. Barth and Bradley (1988) indicate that GAAP-solvent S&Ls held around 63 percent of total assets in loans at the end of 1987, compared to 68 percent at the average REB and the 67.5 percent at the average 5REB.

However, the thrifts held 56 percent of total assets in mortgage loans, while the average REB and 5REB held only 47 percent and 49 percent of assets in total real estate loans, respectively. In addition, mortgage-backed securities were a much more important component of thrift portfolios -- 15 percent of total assets compared to an average of around 1.5 percent for the real estate banks. Given that thrifts have experienced so much difficulty over the 1978-1988 period, whereas the real estate banks in this study's sample have not, this suggests that there may be practical limits to forced specialization, beyond which problems of lack of diversification may swamp the benefits of specialization. In short, the results of this study raise particular cautions about present legislative efforts to reduce potential diversification of thrift institutions as part of the reform of the thrift industry.

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Table 1

Size Distribution of Banks
Number of banks
Asset size categories in $ millions

Sample	Assets category	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
REB	0- 10	183	99	62	39	25	24	35	31	21	30	43
	10- 25	387	235	167	122	76	57	71	89	107	173	226
	25- 50	240	172	145	102	74	54	67	103	137	247	314
	50- 100	97	68	64	55	38	45	79	113	133	236	354
	100- 500	48	35	41	33	31	23	33	85	124	209	349
	500-1000		1	1	2	3	2	3	4	7	20	29
	>1000	1	1	2	2	2	2	1	5	6	11	22
TOTAL		956	611	482	355	249	207	289	430	535	926	1328
SREB	0- 10	47	40	33	27	21	13	13	11	3	3	3
	10- 25	107	95	86	79	59	42	43	37	33	28	29
	25- 50	70	73	75	68	64	40	40	46	45	59	53
	50- 100	31	31	35	33	27	29	49	50	51	61	68
	100- 500	19	21	23	19	22	14	25	35	38	49	59
	500-1000		1	1	1	1	1	2	2	1	5	8
	>1000	1	1	1	1	1	1		1	2	2	1
TOTAL		275	262	254	228	195	140	172	182	173	207	221
CB	0- 10	3,357	3,047	2,725	2,325	2,024	1,738	1,493	1,306	1,089	949	826
	10- 25	4,438	4,501	4,503	4,452	4,310	4,192	4,048	3,883	3,631	3,270	3,068
	25- 50	2,827	3,115	3,305	3,501	3,609	3,651	3,655	3,576	3,491	3,295	3,038
	50- 100	1,451	1,573	1,763	1,964	2,229	2,442	2,547	2,591	2,681	2,534	2,323
	100- 500	964	1,087	1,210	1,341	1,487	1,651	1,787	1,879	1,947	1,859	1,747
	500-1000	127	136	147	158	175	176	192	189	185	175	156
	>1000	19	32	45	66	74	97	54	111	130	108	233
TOTAL		13,183	13,493	13,698	13,807	13,908	13,947	13,776	13,526	13,154	12,270	11,391

Table 2

Aggregate Risk-Return Measures
(Percent or annual percentage rate, as appropriate)

	(1)			(2)			(3)			(4)		
	Mean ROA			Stan. dev. ROA			Mean equity capital			Typical Z		
Year	REB	5REB	CB	REB	5REB	CB	REB	5REB	CB	REB	5REB	CB
1978	.99	1.00	1.00	.47**	.36**	.70	8.00**	7.58**	8.62	19.26	24.13	13.77
1979	1.08**	1.06**	1.14	.49**	.40**	.95	7.99**	7.73**	8.81	18.34	21.81	10.51
1980	.90**	.92**	1.19	.63**	.51**	.79	8.02**	7.88**	9.06	14.23	17.19	13.04
1981	.77**	.83**	1.16	.75**	.59**	.86	8.25**	8.07**	9.16	11.98	15.02	11.94
1982	.62**	.74**	1.01	1.28**	.87**	1.03	8.07**	7.88**	9.26	6.76	9.89	9.99
1983	.71*	.96	.87	1.09	.74**	1.17	8.51*	7.93**	9.21	8.45	12.01	8.61
1984	.62	.92**	.70	1.30	.77**	1.29	8.86	7.87**	9.19	7.27	11.41	7.65
1985	.64	.92**	.60	1.18**	.78**	1.45	8.27**	7.59**	9.14	7.53	10.95	6.77
1986	.53	.87**	.44	1.36**	.86**	1.49	8.07**	7.35**	8.95	6.33	9.57	8.29
1987	.64**	.87**	.49	1.33*	.88**	1.40	8.26**	7.56**	8.90	6.71	9.57	6.78
1988	.94**	.92**	.64	1.15**	.94**	1.28	8.22**	7.76**	9.15	7.77	9.27	7.63

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.

Table 3

Disaggregate Risk Measures
(Percent)

	(1) Mean net loan losses[1]			(2) Mean past due loans[1] ≥ 90 days			(3) Mean past due real estate loans ≥ 90 days[2]			(4) Mean repossessed real estate		
Year	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB
1978	.16**	.13**	.33							.5**	.6**	2.3
1979	.17**	.15**	.33							.5**	.5**	2.0
1980	.23**	.19**	.43							.5**	.6**	2.2
1981	.27**	.24**	.47							.8**	.7**	2.5
1982	.43**	.38**	.68							1.1**	1.0**	3.2
1983	.37**	.29**	.79	1.7	1.6	1.4	1.7	1.5	1.7	1.6**	1.4**	4.8
1984	.44**	.32**	.92	1.3	1.3	1.3	1.1**	1.2*	1.5	1.7*	1.3*	5.9
1985	.59**	.44**	1.31	1.1	1.2	1.2	.9**	1.1**	1.5	1.4**	1.1**	5.0
1986	.65**	.52**	1.52	.9**	1.0*	1.2	.8**	.9**	1.2	1.8**	1.3**	5.8
1987	.59**	.47**	1.10	.8**	.8**	.9	.6**	.6**	1.0	1.8**	1.5**	7.4
1988	.46**	.37**	.84	.6**	.7	.8	.5**	.6**	.8	1.9**	1.5**	5.8

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.

[1] Percent of total loans.

[2] Percent of real estate loans.

Table 4

Mean Ratios of Selected Expenses to Total Assets
(Percent)

	Total oper exp			Interest expense			Nonint expense			Loan loss provisions		
Year	RED	SRED	CB	RED	SRED	CB	RED	SRED	CB	RED	SRED	CB
1978	6.76**	6.78*	6.64	3.95**	4.04**	3.86	2.81**	2.78**	3.08	.21**	.18*	.30
1979	7.33	7.41	7.37	4.52**	4.60**	4.19	2.81**	2.81**	3.18	.20**	.18**	.30
1980	8.62	8.63	8.64	5.63**	5.69**	5.32	2.99**	2.94**	3.32	.21**	.20**	.33
1981	10.36*	10.27**	10.52	7.11	7.14	7.07	3.24**	3.13**	3.46	.25**	.23**	.35
1982	11.02*	10.82	10.79	7.40	7.47**	7.27	3.61	3.35*	3.52	.30**	.34**	.40
1983	9.68	9.78	9.73	6.05	6.36	6.25	3.63	3.42	3.48	.39**	.33**	.57
1984	10.70**	10.41**	10.08	6.64	6.80*	6.65	4.06**	3.60	3.44	.56**	.41**	.70
1985	10.11**	9.91**	9.46	6.14**	6.39**	5.97	3.97**	3.52	3.50	.67**	.48**	.92
1986	9.23**	9.05**	8.68	5.37**	5.57**	5.20	3.86**	3.48	3.48	.71**	.51**	.97
1987	8.50**	8.27*	8.10	4.81**	4.99**	4.64	3.67**	3.28*	3.46	.61**	.47**	.74
1988	8.75**	8.43	8.31	5.11**	5.27**	4.84	3.64**	3.16**	3.48	.50**	.40**	.59

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.

Table 5

Asset Composition

A. Mean percent of total assets

	Liquid assets			Total loans			Other assets		
Year	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB
1978	23.05**	21.93**	31.14	68.84**	70.41**	50.71	10.57**	9.67**	20.04
1979	21.55**	20.76**	30.29	65.49**	66.71**	48.25	13.19**	12.74**	21.64
1980	23.39**	22.71**	32.50	63.81**	64.77**	45.94	13.00**	12.66**	21.72
1981	24.91**	24.64**	34.37	62.85**	63.27**	44.07	12.52**	12.38**	21.69
1982	25.17**	25.35**	35.12	62.56**	62.42**	43.07	12.42**	12.42**	21.89
1983	24.10**	24.97**	36.17	63.80**	62.51**	42.52	12.28**	12.62**	21.38
1984	22.07**	23.53**	35.59	67.07**	65.01**	44.68	11.13**	11.64**	19.82
1985	21.14**	21.94**	35.37	68.40**	66.90**	46.04	10.63**	11.40**	18.69
1986	21.48**	21.60**	36.81	68.39**	67.12**	45.43	10.25**	11.46**	17.86
1987	21.80**	21.22**	37.83	67.99**	67.53**	44.90	10.38**	11.36**	17.39
1988	21.36**	20.40**	37.89	68.91**	69.35**	45.02	9.94**	10.50**	17.22

	Total real estate loans			Consumer loans			Commercial loans			Other loans		
Year	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB
1978	45.54**	48.92**	19.62	14.80**	13.48**	17.87	7.58**	7.18**	12.20	0.93	0.84*	1.02
1979	44.81**	46.69**	19.01	13.32**	12.71**	16.71	6.60**	6.60**	11.63	0.76*	0.71**	0.90
1980	44.57**	46.03**	18.43	11.77**	11.51**	15.12	6.75**	6.56**	11.52	0.72*	0.67**	0.86
1981	44.32**	45.38**	17.57	10.71**	10.71**	13.67	7.13**	6.51**	11.99	0.69*	0.67**	0.85
1982	44.68**	45.19**	16.76	9.65**	9.58**	12.72	7.55**	7.03**	12.74	0.69*	0.64**	0.85
1983	45.19**	45.27**	16.70	9.30**	9.01**	12.19	8.52**	7.63**	12.83	0.78	0.60**	0.80
1984	45.12**	45.06**	17.54	10.26**	10.27**	12.31	10.49**	8.59**	13.52	1.21	1.09*	1.32
1985	45.41**	46.45**	18.24	10.18**	10.18**	12.57	11.33**	8.87**	13.62	1.47	1.40	1.60
1986	46.12**	47.58**	19.08	9.76**	9.36**	12.00	10.97**	8.71**	12.82	1.54	1.48	1.53
1987	46.72**	48.99**	20.13	9.83**	9.04**	11.23	10.06**	8.03**	12.18	1.38	1.46	1.35
1988	48.03**	51.24**	20.89	9.64**	8.83**	11.04	9.97**	8.05**	11.90	1.26	1.23	1.18

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.

Table 5 (cont'd)

Asset Composition

B. Mean percent of total real estate loans

	1-4 families residential property loans			≥5 families residential property loans		
Year	REB	SREB	CB	REB	SREB	CB
1978	60.11**	62.50**	47.22	1.40	1.49	1.56
1979	69.38**	70.69**	53.04	1.24*	1.38	1.51
1980	70.93**	71.36**	54.21	1.31	1.30	1.44
1981	70.97**	72.05**	54.76	1.68	1.27	1.45
1982	69.12**	70.63**	54.81	1.96	1.54	1.51
1983	61.41**	65.53**	54.53	2.62**	2.19	1.66
1984	55.67**	61.99**	53.79	2.56**	2.11	1.79
1985	53.69**	61.59**	53.47	2.65**	1.93	1.80
1986	52.62**	59.27**	52.74	2.74**	2.06	1.88
1987	54.54**	60.98**	52.48	2.41**	2.01	1.84
1988	56.23**	62.52**	52.54	2.32**	1.84	1.71

	Nonfarm nonresidential property loans			Construction and land development loans			Loans secured by farm land		
Year	REB	SREB	CB	REB	SREB	CB	REB	SREB	CB
1978	14.93**	15.61**	21.85	4.69**	4.30**	7.74	9.14**	6.75**	13.51
1979	15.94**	16.39**	23.11	4.68**	4.39**	8.72	8.55**	6.95**	13.31
1980	17.06**	16.96**	23.41	3.91**	3.70**	8.17	6.66**	6.57**	12.49
1981	18.12**	17.15**	23.50	3.78**	3.46**	8.00	5.50**	5.97**	12.02
1982	18.76**	18.39*	23.77	5.10**	3.44**	7.99	4.89**	5.82**	11.60
1983	21.06*	19.56**	23.64	10.18	6.86	8.39	4.54**	5.63**	11.46
1984	22.72	22.22	23.37	14.89**	8.28	8.85	3.41**	4.59**	11.69
1985	25.16	23.87	23.67	14.98**	7.84	8.64	3.10**	4.41**	11.97
1986	26.87**	25.49	24.20	14.17**	9.03	8.10	3.21**	3.87**	12.67
1987	27.64**	24.64	24.34	11.40**	8.34	7.11	3.63**	3.92**	13.79
1988	26.81**	23.78	24.13	10.25**	7.88	6.64	3.68**	3.67**	14.62

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.

Table 6
Dynamic Adjustment of Real Estate Loans by REBs
(RETA Ratios Expressed as Percent)

Year	CB Sample	Full REB Sample in Year t	Banks in REB Sample All 10 Years		Banks not in REB sample in year t, but in REB Sample in					
	(1)	(2)	(3)		(4)		(5)		(6)	
					1 Other Year		4 Other Years		7 Other Years	
	Mean RETA	Mean RETA	No.	Mean RETA	No.	Mean RETA	No.	Mean RETA	No.	Mean RETA
1978	19.6	45.5	32	51.6	411	26.0	71	27.7	5	31.5
1979	19.0	44.8	-	49.7	668	28.9	92	27.4	5	29.7
1980	18.4	44.6	-	49.1	665	27.2	104	27.8	8	33.4
1981	17.6	44.3	-	47.6	680	25.9	121	29.0	16	36.9
1982	16.8	44.7	-	46.7	679	24.2	180	30.9	17	36.6
1983	16.7	45.2	-	45.9	683	24.2	174	30.9	22	37.5
1984	17.5	45.1	-	47.6	700	25.5	163	32.7	18	37.8
1985	18.2	45.4	-	48.6	691	26.7	101	32.7	18	34.8
1986	19.1	46.1	-	45.7	710	28.6	92	32.2	21	34.5
1987	20.1	46.7	-	52.3	657	32.7	72	32.2	13	35.9
1988	20.9	48.0	-	55.3	291	30.3	59	32.2	8	32.9

Table 7

Mean Ratios of Selected Liabilities Over Total Liabilities
(Percent)

	DD & NOWS			Time & savings			Other liabilities		
Year	REB	5REB	CB	REB	5REB	CB	REB	5REB	CB
1978	26.27**	24.66**	34.38	71.64**	73.23**	63.18	1.24**	1.18**	1.64
1979	23.88**	23.02**	32.76	73.77**	74.57**	64.25	1.11**	1.04**	1.59
1980	22.14**	21.61**	30.18	75.31**	76.01**	66.59	1.03**	1.01**	1.50
1981	19.85**	19.20**	25.12	77.21**	78.22**	70.99	1.02**	1.02**	1.46
1982	17.82**	17.03**	21.29	78.65**	79.78**	74.32	1.30	1.13**	1.42
1983	16.82**	16.04**	18.97	79.99**	80.77**	77.33	2.11*	1.34	1.39
1984	20.02**	19.34**	21.72	75.72*	77.08**	74.28	1.35**	1.18	1.04
1985	15.48**	14.19**	16.54	80.66	83.07**	80.21	1.22*	0.95	0.88
1986	15.89	14.49**	16.16	80.94	82.78**	80.91	1.15**	0.97*	0.85
1987	15.36	13.50**	15.55	81.65	83.58**	81.57	1.05**	0.86*	0.79
1988	14.41*	12.67**	14.88	82.22	85.12**	82.13	0.83**	0.72	0.72

* Significantly different from CB at the 95 percent level or better.

** Significantly different from CB at the 99 percent level or better.